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NEW SECURITIES POWERS FOR BANK HOLDING COMPANIES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

THE ISSUE OF EXPANDING BANK POWERS TO INCLUDE THE UNDERWRITING AND DEALING IN MUTUAL FUNDS, MORTGAGE-BACKED SECURITIES AND MUNICIPAL REVENUE BONDS

AUGUST 6, 1987

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NEW SECURITIES POWERS FOR BANK HOLDING COMPANIES

THURSDAY, AUGUST 6, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Garn, Heinz, D'Amato, Hecht, Bond, Chafee, and Karnes.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

Today we continue our hearings on comprehensive reform of the financial services industry. We began this series of hearings several weeks ago with the testimony on broad-based reform issues by Federal Reserve Bank President Gerald Corrigan, former Citicorp Chairman Walter Wriston, and Goldman Sachs Managing Partner John Weinberg. Our hearings continued last week with a thorough evaluation of the likely public benefits and costs of expanding banks' insurance powers, and an in-depth review of the history and current relevance of the Glass-Steagall Act. Yesterday we heard from proponents of two divergent approaches to comprehensive reform: Congressman Carper, with his focus on State authorized powers; and the Association of Bank Holding Companies, with its more general proposal for a financial services holding company.

This morning we will hear from parties who might stand to benefit from expanding the securities powers of bank holding companies. I want to see us identify and evaluate the benefits and costs to the public—I repeat, to the public—of permitting bank holding companies to underwrite mutual funds, mortgage-backed securities, and municipal revenue bonds. I particularly want us to consider whether increased competition in those areas would benefit consumers by reducing the cost and increasing the supply of such services. It is my personal belief, based on the evidence I've seen so far, that it would be in the public interest to grant those powers with appropriate safeguards.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, this morning the committee continues its examination of the structure of our domestic financial markets and today's hearing, as you indicated, focuses on the granting of new securities powers to banks in an effort to increase the pace of financial deregulation.

As many of my colleagues know and for many of the reasons that I have repeatedly stated on the record, I have opposed the expansion of these powers to banks.

While some may argue that the granting of the new securities power may provide some marginal benefits to the consumers in terms of new financial products and services, I believe that these marginal benefits are far outweighed by the increased threat to the safety and soundness of the financial system such a new grant of powers would pose.

Thus, the benefits of new powers are marginal and speculative while the shortcomings associated with such powers are certain and disastrous.

Further, if we are going to engage in comprehensive legislative reform, it must truly be comprehensive. We must overhaul the entire system of the financial regulations and I don't consider the piecemeal grant of a few securities powers that will only be utilized by a dozen megacommercial banks as constituting comprehensive reform.

I would also supplement this morning's record with two articles that bear directly on the topic of this series of hearings conducted by the committee.

The first article contains statistics which appear in the July 11, 1987 edition of The Economist. These statistics suggest that while American banks may not be the largest in the world, they are still the most profitable, as measured by net income. Clearly, these statistics demonstrate that size alone is not a proper measure of competitiveness or profitability of U.S. banks.

For example, the statistics show that Citicorp, the sixth largest bank in the world, earned $1,058,000,000 in net income in 1986. The net income for 1986 of the two largest banks in the world was $512 million for Dai-Ichi Kangyo, and $525 million for the Fuji Bank. So combined, those two banks earned less than Citicorp. They earned $1,037,000,000 or $21 million less than the net income of Citibank.

These figures also demonstrate that Citibank, despite its earnings, is not as competitive as it might be. For example, in 1986, Citicorp earned $12,000 in net income per employee, while Dai-Ichi Kangyo earned $26,000 per employee, and the Industrial Bank of Japan, 7th largest in the world, earned $76,000 per employee.

These figures support the following conclusions. One, size alone is no measure of profitability; two, the largest American bank could be more competitive and even more profitable if it cut down its overhead and functioned more efficiently; three, large American banks earned a great deal of net income in 1986 and do not need more powers to continue to remain profitable, a myth which is being spread regularly throughout this country. Instead, they need to concentrate on performing their traditional functions more efficiently. Fourth, American banks have fallen out of the ranks of the world's largest if that's a relevant concern for a myriad of reasons

that have nothing to do with the need for expanded powers. The grant of expanded powers will not propel them back into the top ten.

The other article, Mr. Chairman, is taken from the June 29, 1987 edition of Forbes and demonstrates the need to coordinate our legislative efforts to reform the financial system with the informal regulations imposed upon financial institutions.

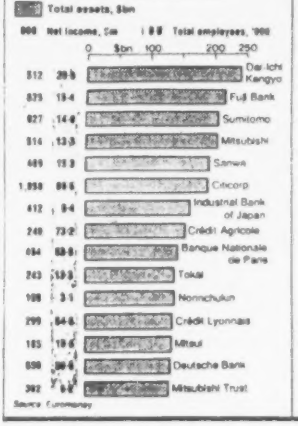
For example, the accounting rules of the Financial Accounting Standards Board that are applied to banks provide that more leeway to dally over reserves against losses than any other corporations enjoy. The article notes that the accounting rules for reserving against losses are strict for everyone except banks and then correctly asks why should they get special treatment? Regrettably, the result of this special treatment for banks results in a kind of big bath approach to accounting that leaves bank shareholders vulnerable to a sudden asset write-down that can send share prices leaping or tumbling.

Mr. Chairman, I look forward to the morning's testimony and would submit the articles as part of my statement.

The CHAIRMAN. Fine.

ECONOMIC AND FINANCIAL INDICATORS 2

FOCUS: BANKS The world's five biggest banks (in terms of assets) are all Japanese. There is now only one American bank—Citicorp—in the top 15. Bank of America, the world's largest bank until the early 1980s, has slipped to 25th place. In 1986, all the big Japanese banks increased their assets by more than 50% in dollar terms, mainly because of the strength of the yen. Japanese banks are also among the most profitable per employee. America's largest bank, Citicorp, earned $12,000 in net income from each employee last year; Dai-Ichi Kangyo got $26,000. At the Industrial Bank of Japan profits per employee were $76,000.



WORLD BOURSES Stockmarkets hit record highs this week in Amsterdam, Brussels, Hongkong, London, Singapore, Sydney, Toronto and Zurich. Only two markets fell: Tokyo lost 1.5%, while political uncertainties knocked 3.1% off Milan.

Stock indices	July 7	1987 high	1987 low	% Change on: one week	one year	record high	31/12/86 in local currency	31/12/86 in $ terms
Australia	1822.1	1862.8	1486.7	+ 5.5	+ 65.6	nil	+ 26.5	+ 33.9
Belgium	5006.1	5006.1	3987.9	+ 4.6	+ 34.9	nil	+ 22.2	+ 28.5
Canada	3984.6	3984.6	3067.8	+ 3.9	+ 29.6	nil	+ 26.7	+ 32.7
France	418.6	460.4	392.0	+ 3.5	+ 14.3	- 9.1	+ 5.2	+ 9.5
W Germany	1886.4	2048.3	1633.8	+ 0.7	+ 3.5	- 17.2	7.8	3.6
Holland	313.6	313.6	257.7	+ 2.2	+ 8.3	nil	+ 12.6	+ 19.2
Hongkong	3238.4	3238.4	2449.9	+ 1.8	+ 84.7	nil	+ 26.0	+ 25.7
Italy	670.0	767.3	673.6	- 3.1	- 5.5	- 26.2	- 7.3	- 6.8
Japan	23818.1	25929.4	18544.0	- 1.5	+ 34.3	- 8.2	+ 26.5	+ 33.7
Singapore	1332.6	1332.6	889.1	+ 5.7	+ 81.7	nil	+ 49.5	+ 52.5
South Africa	1954.0	1957.0	1423.0	+ 1.8	+ 84.3	- 0.2	+ 38.0	+ 47.1
Spain	250.3	258.0	202.8	+ 1.1	+ 42.5	- 2.2	+ 20.2	+ 25.1
Sweden	2754.2	2782.1	2111.4	+ 1.8	+ 11.2	- 1.0	+ 12.0	+ 18.1
Switzerland	619.1	620.7	564.5	+ 1.0	+ 12.9	- 0.3	+ 5.1	+ 10.5
UK	1836.8	1836.8	1320.2	+ 3.0	+ 39.4	nil	+ 39.8	+ 52.6
USA	2449.5	2451.1	1927.3	+ 1.3	+ 34.5	- 0.1	+ 29.2	+ 29.2

MONEY AND INTEREST RATES The 12-month rate of increase in Japan's M1 measure of the money supply rose to 12.9% in May; growth in M2 plus CDs slowed to 10.2%. Banks in Belgium cut their prime lending rates by half a point.

	Money supply % rise on year ago Narrow (M1)	Broad‡	Interest rates % p.a. (Tuesday, except bonds which are previous Friday) Money market Overnight	3 months	Commercial banks Prime lending	Deposits 3 months	Bond yields Gov't long-term	Corporate	Eurocurrency Deposits 3 months	Bonds
Australia	+17.6	+12.5 (5)	12.25	13.20	16.00	12.50	13.20	14.20	13.72	14.65
Belgium	+ 8.1	+11.4(12)	7.75	8.65	8.75	6.25	8.00	8.11	6.75	na
Canada	+17.3	+11.6 (6)	8.75	8.65	9.50	7.80	9.64	10.42	8.31	10.05
France	+ 2.0	+ 4.1 (3)	7.56	7.94	9.45	8.00	9.19	10.38	8.06	9.64
W Germany	+ 9.9	+ 6.4 (5)	3.45	3.80	6.00	3.46	6.00	5.80	3.68	4.94
Holland	+ 7.2	+ 3.9 (4)	5.31	5.19	7.00	5.19	6.33	8.73	5.75	6.52
Italy	+ 9.7	+ 9.4 (1)	11.00	11.38	12.50	na	10.67	10.12	9.63	na
Japan	+12.9	+10.2 (5)	3.19	3.75	3.38	1.76	4.14	4.20	4.09	4.69
Spain	+15.3	+10.8 (4)	18.69	17.85	17.00	6.50	13.13	13.50	14.00	na
Sweden	na	+10.1 (4)	10.10	9.05	11.50	8.53	11.23	12.25	8.88	na
Switzerland	+ 5.5	+ 9.1 (4)	2.06	3.69	7.00	3.25	4.10	4.56	3.75	4.75
UK	+23.7	+18.9 (5)	5.19	9.18	10.00	9.06	9.33	10.18	9.16	10.07
USA	+14.2	+ 7.3 (5)	6.68	6.85	8.25	6.85	8.43	9.25	7.00	8.42

Other key rates in London 3-mth Treasury Bills 8.8%, 7-day interbank 9.1%, clearing banks' 7-day notice 3.3%. Eurodollar rates (Libor): 3 mths 7.1%, 6 mths 7.2%.

‡M2 except Australia, Canada, Spain, Switzerland, USA, UK, W. Germany M3, Japan M2 + CDs. Definitions of interest rates quoted available on request. Sources: Bank of Bilbao, Chase Manhattan, Chase Econometrics, Banque de Commerce (Belgium), Nederlandse Crediethank, Credit Lyonnais, Svenska Handelsbanken, ANZ Bank, Credit Suisse First Boston. These rates are indicative only and cannot be construed as offers by these banks.

TRADE, EXCHANGE RATES AND RESERVES Japan's visible-trade surplus fell slightly to $101.8 billion in the 12 months to May—the first decline since March 1985; its current-account surplus also fell, by $708m to $93.1 billion. West Germany's visible-trade surplus continued to widen, to $62.3 billion in the year to May. The dollar rose 0.7% in trade-weighted terms during the week, to its highest level for three and a half months; the yen fell 1.6%, the D-mark 0.2%.

	trade balance‡ $bn latest month	latest 12 months	current-account balance $bn latest 12 mths	trade-weighted‡‡ exchange rate latest	year ago	currency units per $ latest	year ago	currency units per £	per SDR	per ecu	foreign reserves†† $bn April	year ago
Australia	+ 0.01 (5)	- 1.4	- 8.6 (5)	55.5	53.0	1.42	1.61	2.30	1.80	1.60	8.4	6.6
Belgium	+ 0.21 (3)	+ 0.3	+ 3.3(12)	100.0	95.4	38.2	44.7	61.8	48.6	43.1	6.9	5.1
Canada	+ 1.18 (4)	+ 8.1	- 6.5 (3)	78.7	78.7	1.32	1.38	2.14	1.69	1.50	5.3	2.8
France	- 0.94 (5)	- 2.2	+ 3.6(12)	71.6	69.2	6.13	6.49	9.92	7.81	6.92	31.8†	26.5†
W Germany	+ 5.95 (5)	+ 62.3	+ 41.1 (5)	146.7	135.7	1.84	2.18	2.98	2.34	2.08	82.0	45.6
Holland	+ 0.60 (3)	+ 2.9	+ 6.7 (9)	134.8	126.1	2.07	2.46	3.36	2.62	2.34	13.1	11.2
Italy	- 1.48 (4)	- 1.1	+ 5.1(12)	47.0	46.5	1332	1492	2157	1696	1504	25.9	17.2
Japan	+ 8.03 (5)	+101.8	+ 93.1 (5)	214.2	212.3	150	181	243	190	169	68.5	31.3
Spain	- 0.90 (5)	- 11.0	+ 3.8 (4)	48.9	48.8	127	139	206	162	143	15.5**	12.5**
Sweden	+ 0.51 (5)	+ 4.5	+ 1.0 (3)	68.4	67.8	6.41	7.09	10.4	8.16	7.23	8.2	6.8
Switzerland	- 0.50 (3)	- 3.6	+ 7.5(12)	171.8	162.1	1.53	1.77	2.49	1.95	1.73	19.7	16.2
UK	- 0.82 (4)	- 12.6	- 1.8 (4)	73.0	75.9	0.62	0.65	—	0.79	0.70	24.4	14.7
USA	-13.32 (4)*	-168.4	-145.5 (3)	103.0	113.8	—	—	1.82	1.27	1.13	35.5	35.4

*†Australia, Canada, Japan, France and UK imports fob, exports fob. All others cif/fob. ‡‡ Bank of England index 1975 = 100. †† Excluding gold. * Not seasonally adjusted. ** February. † March.*

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Numbers Game

Accounting rules for reserves against loss are strict for everyone except the banks. Why should they get special treatment?

Judgment? Or foot-dragging?

By Laura Jereski

WHY HAS IT TAKEN so long for Citicorp and Chase Manhattan to beef up their loan-loss reserves against all those Latin loans that everyone has known for years would probably never be repaid? Because as the official rules of the Financial Accounting Standards Board are written, banks have more leeway to dally over such things than any other corporations enjoy. The result has been a kind of "big bath" approach to accounting that leaves bank shareholders vulnerable to a sudden asset writedown that can send share prices leaping or tumbling.

The problem goes back to 1972, when the Financial Accounting Standards Board put forth rules strictly limiting the use of reserves on company balance sheets. The board rightly feared that loose "reserving" rules would permit companies to use the money, ostensibly set aside against some potential future loss, to smooth out earnings. Companies such as, say, property and casualty insurers could draw down reserves to help boost earnings in years of catastrophic loss and squirrel away a little extra in good years in order to avoid showing unsustainably robust earnings.

Thus, the board ruled that companies could accumulate reserves only when a liability had actually been incurred or an asset probably impaired. Moreover, the loss needed to be one that could reasonably be measured or estimated. In short, no reserves against the risk of future product liability lawsuits, or tornadoes that had not yet occurred. Explains Peter Horozco, an accountant with the board, "The board's approach has been: If the event that causes the loss hasn't occurred yet, then it's not yet a loss."

But when it comes to banking, the very specificity of the board's language created an enormous loophole. Exactly when, for example, does a 20-year loan to some deadbeat banana republic become a bad debt? Answers Michael Esposito, chief financial officer for Chase, "It all comes down to a matter of judgment."

Fair enough, but as long ago as the late 1970s plenty of voices were warning that the rush to lend to shaky Third World borrowers was foolhardy in the extreme (FORBES, *June 23, 1980 et seq.*). Since then, the rush to lend has given way to a rush to renegotiate. Since 1982 virtually all the major lenders found themselves regularly embroiled in renegotiation of loans to Mexico, Venezuela, Argentina and Brazil. In that period, for example, the face amount of Chase loans that were not paying interest rose 60%, to $2 billion (not counting $2.6 billion of nonaccruing loans to Brazil and Ecuador). But Chase's reserves against loan losses of all kinds rose by only $507 million, to $1.1 billion. Suddenly, last month, on the heels of Citicorp's $3 billion hit, Chase also exercised its "judgment" as to the "dubious worth" of a portion of the assets in question and added another $1.6 billion to its reserves.

Wall Street has long thought that an awful lot of bankerly "judgment" was mere foot-dragging. The price/earnings ratio of 24 major banks, as measured by the Keefe, Bruyette & Woods index, has lately been little more than half that of the Standard & Poor's 500. That's largely because of the doubtful loans on the banks' balance sheets.

The banks themselves are living by a convenient double standard. Take credit card losses. At Chase Manhattan, which has been aggressively pursuing this consumer business for years, credit card losses currently run as high as 5% on the newer loans in the portfolio. That is up from about 2% only four years ago. Significantly, the bank automatically includes potential losses from these loans in its reserves virtually from the moment that they are made, knowing from experience that on average about 5% can be expected to go bad and be written off as worthless inside of 180 days. Similar treatment is given to home mortgage loans.

Big banks like to argue that their megabuck international loans are somehow special cases, not as predictable as consumer loans. Says Thomas Jones, chief of financial controls at Citicorp, "If a country says it can't pay, it just means the borrower may need more lenient terms. If a country says it won't pay, that's something different. But as long as the principal value of the loan isn't impaired, the accountants say we can't reserve." That's why Citicorp points to "other factors" in its $3 billion decision, such as worsening renegotiation terms and global economic problems.

But who's kidding whom? Some portion of "principal value" would seem to be "impaired" on any loan that gets regularly restructured to help out the borrower. Says James McDermott, a bank analyst with Keefe, Bruyette & Woods, "To the extent that the accountants didn't encourage bank management to be more aggressive on reserving, that has clearly proved to be a problem. It's not as if no one did anything—reserves were 1% of loans in 1982, and they are twice that today. They just did not do enough." ■

The CHAIRMAN. Senator Hecht?
Senator HECHT. No statement.
The CHAIRMAN. Senator Garn.
Senator GARN. Thank you, Mr. Chairman.

I'm sure that over the last 12 years virtually everyone here has heard me and my opinions on these issues so many times that I will not do it to them again. I will simply place my statement in the record.

The CHAIRMAN. Thank you very much. Senators Dixon, Heinz, Chafee, and Karnes have statements they wish to be placed in the record.

STATEMENT OF SENATOR JAKE GARN

Today, we begin again hearings on the need to authorize new securities powers for bank holding companies.

To a large extent, the demand for bank holding company entry into the securities area has already been demonstrated by the marketplace. The demand is there. The need is there. The benefits of bank participation in the securities area has been clearly established by the testimony this committee heard last week, and in the weeks and months of testimony on this subject solicited by this committee in the past 12 years. Just a few days ago we heard expert witnesses testify that the securities area is presently overconcentrated and that bank entry will lower costs and increase competition.

Unfortunately, instead of passing remedial legislation to enhance the ability of bank holding companies to enter into and compete in the securities field, the Congress has taken the opposite approach. It has prohibited regulatory actions which will increase the securities activities of banks and bank holding companies under current law. However, this restriction on regulatory action will expire on March 1, 1988. As I said on the floor last Tuesday, before that date I will work for the necessary legislative changes, so that upon the expiration of the moratorium, we will be able to move forward with appropriate new securities powers for bank holding companies.

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I am pleased to be here this morning as the Banking Committee continues its series of hearings on financial services industry reform issues. The issue before us today is one that has been before this committee for a long time—limited securities powers for bank holding companies.

As many of my colleagues know, I have supported significant expansion of bank holding company asset powers in this area in the past and I continue to do so. Fundamentally, I support this expansion of powers because I believe that banks are performing many securities activities already. Banks can, for example, underwrite general obligation municipal bonds; it makes no sense to forbid them to underwrite revenue bonds. Banks also deal in mortgage-backed securities, but current restrictions make these transactions more complex and more expensive for commercial banks than for investment banks.

Financial markets are changing. Financing that used to be provided through traditional bank loans is increasingly provided through securities products. We need to recognize the changed market situation, and quickly act on long overdue banking law reforms.

STATEMENT OF SENATOR JOHN HEINZ

Mr. Chairman, I join you in welcoming our distinguished panels of witnesses today as the committee examines the issue of expanding bank powers to include the underwriting and dealing in mutual funds, mortgage-backed securities, and municipal revenue bonds.

The policy debate over the Glass-Steagall Act is not new. In fact, the intensity of the disagreement regarding the act is at its peak. Many banks and regulators claim that the act is an anachronism, given the changes in technology, changes in banks' long-term capital needs, and changes in the financial markets brought on by deregulation, disintermediation, securitization, and internationalization.

I am the first to say that the Glass-Steagall Act doesn't look the way it used to. It has been so riddled with holes that it looks more like a piece of Swiss cheese rather than a statute intended to separate the markets of banking and commerce. But, is it an anachronism? Is it a law whose time has come and gone?

I have deep reservations about the wholesale repeal of the act unless certain issues are considered and resolved.

For example, in the testimony today, we will hear that unlike in the past, commercial banks no longer appear to be "special" corporate entities today; that, for purposes of public policy, banking should be treated no differently than any other competitive sector and; that, any restrictions unique to banks should be removed.

Mr. Chairman, it may be true that banks are in the process of redefining their character and realigning their traditional functions. Certainly, the underlying economic forces have stimulated this change. To a certain extent, these forces have been in conflict with the regulatory structure governing banks. However, there is one characteristic that is unique to the banking industry and no other financial intermediary in this country: Federal deposit insurance.

Far from being a regulatory shackle, deposit insurance is a competitive advantage for intermediaries. With FDIC insurance, there are corresponding substantial explicit arrangements and the unstated but likely guarantee of the full taxing power of the Federal Government to protect insured deposits. My concern is if the full integration of commercial and investment banking occurs, will the explicit and implicit deposit insurance guarantee propagate to the securities activities of the bank?

While advocates support the concept of corporate separateness—insulating the bank by putting the securities activities in a separate subsidiary—I am concerned whether the "subsidy" provided by deposit insurance would still propagate to the subsidiary.

In addition, the committee must examine whether the corporate separation concept would shield against the risks of conflicts of interest, preferential treatment, and self-dealing.

Mr. Chairman, I welcome a full discussion of these issues. The merits of bank involvement in securities activities may be there. But so are the problems. I look forward to hearing the witnesses' testimony, in particular, their responses to the issues I have raised.

STATEMENT OF SENATOR JOHN H. CHAFEE

Mr. Chairman. I commend you for holding these hearings on securities powers for commercial banks. I am pleased to notice the agreement among the witnesses on this issue.

I would hope that, as the follow-on banking bill emerges after a full set of hearings and committee deliberations, the matters we discuss today will be seen for what they are—increasing the ability of commercial banks to provide services—without impacting the safety and soundness question—improving competition, and lowering costs for the users of these services especially consumers.

I would also hope that these powers could be seen as an evolutionary outgrowth of the marketplace's requirements for financial services and not as individual chips to be grudgingly granted to banks to encourage them to agree to some limited vision of that world.

OPENING STATEMENT OF SENATOR DAVID K. KARNES

Mr. Chairman, I want to join with my distinguished colleagues in welcoming the impressive array of witnesses. I want to thank them for their informative written testimony and for their participation in this committee's continuing discussion of expanded bank powers.

After reveiwing the written testimony, I was certainly impressed with the basic concept from the majority of the witnesses; that is that allowing bank holding companies to increase their participation in the securities market will ultimately benefit the consumer. To the extent that this Congress can fashion a framework that will adequately address the safety and soundness issue, it certainly seems that the public will ultimately be the winner by allowing increased competition in the securities area.

The CHAIRMAN. I'm going to ask the gentlemen who have arrived to come forward. We wanted to have all six of you here because I think you all have a part to play in answering questions that would go back and forth affecting mutual funds, mortgage-backed securities, and municipal revenue bonds. We're going to have you make your statements to begin and then we will get into questions.

You will have 5 minutes for your oral statement and your written statement will be placed in the record in full.

Go right ahead, Mr. Kaufman.

STATEMENT OF GEORGE G. KAUFMAN, JOHN F. SMITH PROFESSOR OF FINANCE AND ECONOMICS, LOYOLA UNIVERSITY OF CHICAGO

Mr. KAUFMAN. Thank you, Mr. Chairman.

I am pleased to testify on the question of securities powers for commercial banks. I will summarize my comments briefly. I have a full statement and a longer paper which I will submit for the record.

This is a particularly hot issue because securities activities appear to many bankers to be where the money is. The appetite of commercial banks, particularly larger ones, for increased participation in this market has been greatly whetted for reasons with which we are all familiar. And increase their participation in the securities market, many banks have.

My review of the securities activities of banks show that contrary to what some may believe the Glass-Steagall Act says or popular statements about the separation of commercial and investment banking, commercial banks are now participating either directly or indirectly in almost every aspect of the securities market.

My understanding of the securities activities in which commercial banks are permitted to participate directly is shown in table 1, which is attached to my statement. It is a long list. But this is an understatement of the overall participation. Banks can engage in prohibited activities that I list in table 2 indirectly through cooperative or joint-like ventures with firms that are legally permitted to provide these services.

As I discuss more fully in my longer statement, banks have also found ways to get around many of the legal and regulatory disadvantages imposed on them and have emphasized their presence in overseas securities markets in which many of the restrictions in the United States do not apply.

Indeed, in a recent advertisement, the Chase Manhattan Bank proudly proclaims that "With offices in 60 countries around the world, Chase has greater international presence than any U.S. investment bank." The ad goes on, "In fact, Chase has offices in almost twice as many countries as the above ten investment banks combined."

You have asked me to focus particularly on the issue of mutual funds. Mutual funds have been an extraordinary boom industry in recent years. The number of equity and long-term bond funds has tripled between 1980 and 1986 from approximately 450 to almost 1,400, and the assets have expanded even faster, by a factor of seven.

Banks cannot sponsor or distribute mutual funds. They can broker funds of others in an agency capacity. They can also manage and advise funds. Because managing mutual funds is where the money generally is, some banks have entered into agreements with investment companies to manage so-called "private label" mutual funds that the sponsoring investment company sells to and buys back from the bank's customers.

A survey of larger banks found that nearly 70 percent offered mutual funds in some form in 1986. This represented a 50-percent increase over 1985. Moreover, about one-half of the remaining banks in the survey planned to offer mutual funds in the near future.

If I am correct in arguing that Glass-Steagall is alive de jure but effectively dead de facto, what is all the shouting about?

On the one hand, although banks are moving rapidly into securities products, they would like to perform these services in the most efficient ways, not in the second or third best ways. As it is both

too late and I believe technically impossible to put the genie back into the bottle and prohibit banks from offering a wide range of securities products, efficiency appears to suggest a de jure repeal of much of Glass-Steagall to catch up with the de facto repeal that has already occurred.

On the other hand, opponents argue unfair competition, excessive risk, conflicts of interest, and excessive economic concentration. Most economists now downplay these factors. With the termination of regulation Q and the ongoing financial problems of the Federal Deposit Insurance Agencies pushing up insurance premiums, banks do not appear now, if they ever did, to have an unfair competitive advantage. Thus, the more competition, the better.

Even if some individual securities activities are risky, the important factor to consider is the interaction of these risks with the bank's existing risks. Although greater diversification does not by itself guarantee reduced overall risk, it makes it easier for good management to do so. The numerous skeletons of dead and dying banks and particularly thrift institutions that are polluting the landscape today should remind us that poor or risk-seeking managers do not need new powers their damage to perform.

Ironically, the potential for conflicts of interest and economic concentration has been reduced significantly in recent years by the effective removal of the Glass-Steagall imposed barriers to entry into commercial banking. Neither evil can persist for long if easy entry exists to induce competition. This, of course, is not to say that conflicts and concentration will not exist in banking, but only to suggest that they will be no better or worse than in other industries. Securities legislation and regulation adopted since 1933 should be applied to commercial banks to the same extent as to their competitors. Antitrust laws should be as adequate in preventing excessive concentration in banking as elsewhere.

What has been happening in recent years is that whether or not commercial banks were ever special in the past, they are not so today. This implies that for purposes of public policy, banking should be treated no differently than any other competitive sector and that any restrictions unique to it should be removed. Much of Glass-Steagall falls into this category. Thank you.

[The complete prepared statement of George G. Kaufman follows:]

SECURITIES POWERS OF COMMERCIAL BANKS

Statement by
George G. Kaufman
(John F. Smith Professor of Finance and Economics,
Loyola University of Chicago)

before the

Senate Committee on Banking, Housing, and Urban Affairs
Washington, D.C.
August 6, 1987

Mr. Chairman, I am pleased to testify on the question of securities powers for commercial banks. This is a particularly hot issue because securities activities appear to many bankers to be where the money currently is. The appetite of commercial banks, particularly larger ones, for increased participation in this market has been greatly whetted by the combination of a booming stock market; high returns to full-line investment banking firms; record financing needs of business firms and governments; advances in computer technology that promise substantial economies of scope in providing new securities activities along with lending, deposit, and other traditional commercial banking services; the development of new highly complex financial instruments, and the internationalization of financial markets. These forces have come into play at the same time that the demand for some permitted lines of commercial banking, such as lending to large high quality commercial customers, appears to be declining and entry by nonbanking firms into many previously protected banking activities has been eased substantially by technological and regulatory changes.

And increase their participation in this area many banks

have. My review of bank securities activities shows that, contrary to what some may believe the Glass-Steagall Act says or statements about the separation of commercial and investment banking, commercial banks are now participating either directly or indirectly in almost every aspect of the securities market. My understanding of the securities activities in which commercial banks are permitted to participate directly is shown in Table 1. But this is an understatement of their overall participation. Banks can engage in prohibited activities listed in Table 2 indirectly through co-operative or joint-like ventures with firms that are legally permitted to provide these services, e.g., full-line securities dealers and mutual fund sponsors.

Moreover, larger banks have found ways to compensate for at least some of the more severe restrictions imposed on them. Banks are disadvantaged relative to security dealers in not being able to hold inventories of corporate securities and thereby being unable to provide customers with immediate execution. However, some have found that the buy and sell lists of large funds, including those that are managed by the banks' own trust departments or other affiliates, that use the banks' brokerage service can serve much the same function. Of course, the banks still cannot experience gains or losses from positioning.

Similarly, while banks are limited to brokering corporate securities in the United States, they may underwrite and deal in these securities in many foreign countries. Citicorp, for example, is reportedly a member of 17 major foreign stock

exchanges, has investment banking offices in some 45 foreign countries, and researches more than 800 foreign stocks that account for about 70 percent of the aggregate capitalization of equities on foreign stock exchanges. With rapidly increasing interest by U.S. investors in foreign securities, this represents a display of marketing power that no investment banks can match. Indeed, in a recent advertisement, the Chase Manhattan Bank proudly proclaims that "with offices in 60 countries around the world, Chase has greater international presence than any U.S. investment bank. In fact, Chase has offices in almost twice as many countries as the above ten investment banks combined." (See Exhibit 1)

Mr. Chairman, you have asked me to focus particularly on the issue of mutual funds. Mutual funds have been an extraordinary boom industry in recent years. The number of equity and long-term bond funds has tripled from 458 to 1,356 between 1980 and 1986, and their assets have expanded even faster by a factor of seven. (And this is not including the sharp runup in stock values since the beginning of 1987.) Money market mutual funds increased by a factor of four in both number and asset size in the same period.

Commercial banks have not stood by idly. The Garn-St Germain Act of 1982 permitted banks to offer MMDAs in competition with money market funds. These accounts are now the largest single type of account at commercial banks and have slowed the growth in money market mutual funds significantly. Since 1974,

banks have been permitted to sponsor and manage closed-end funds and to manage but not sponsor open-end (mutual) funds, although they can effectively sponsor and manage mutual funds for IRAs.

Because managing mutual funds is where the money generally is, some banks have entered into agreements with investment companies to manage "private label" mutual funds that the sponsoring investment company sells to and buys back from the banks' customers. (An ad for one of these funds managed by the First National Bank of Chicago and distributed by Dreyfus is shown in Exhibit 2.) Banks can, of course, broker mutual funds in an agency capacity. A survey of larger banks reported in the American Banker found that nearly 70 percent offered mutual funds in some form in 1986. This represented a 50 percent increase over 1985. Moreover, about one-half of the remaining banks planned to offer mutual funds in the near future. A more recent survey by the Bank Administration Institute found even higher percentages for banks between $1 and $5 billion in assets.

Recently, the Chase Manhattan Bank has developed a highly imaginative and sophisticated new securities product. This "market index investment" account is a fixed-term deposit, whose interest return is partially tied to the performance of the S&P 500 stock index during the period. Because it is a deposit account, its principal is paid at maturity and is fully protected up to $100,000 by the FDIC. The bank offers customers a choice of different minimum guaranteed returns in exchange for different degrees of participation in stock market gains. Basically, the

higher the guaranteed floor rate, the smaller the depositor's participation in any gain in stock prices. The Chase manages its risk exposure by investing partially in S&P 500 index futures. Because these contracts are settled in cash, they are viewed as eligible investments for banks by the regulatory agencies. Economically, although not legally, Chase is acting as a mutual fund sponsor and manager. To investors, the account is basically equivalent to an indexed stock market mutual fund account with an embedded European put option exercisable at maturity at the guaranteed floor value.

These recent developments have served to reinforce my conclusion of 1984 that:

> it would appear that the limitations on commercial banks' activities in providing securities and ancillary services are to a large extent the fault of the banks themselves. They were inhibited, for good or for bad reasons, as much by internal, self-imposed constraints (including lack of imagination) as by external constraints.... While enactment of sweeping new banking legislation is improbable, a continued nibbling away of the elements of separateness between commercial banking and investment banking does seem likely.... Indeed, it is not too farfetched to predict that Glass-Steagall will be no more effective in maintaining a separation between commercial and investment banking in a few years than the McFadden Act and the Douglas Amendment...have been in preventing interstate banking.[1]

If I am correct in arguing that Glass-Steagall is alive de jure but effectively dead de facto, what is all the shouting about? On the one hand, banks argue that they are disadvantaged

1. George G. Kaufman, "The Securities Activities of Commercial Banks: Legal and Economic Analysis", in Richard C. Aspinwall and Robert A. Eisenbeis, eds., Handbook for Banking Strategy (New York: John Wiley & Sons, 1985), pp. 696-698.

relative to most other industries because when the demand for the products of those industries declines, the individual component firms have the choice of shifting their operations to more promising product lines, scaling back their operations, or closing shop. Because the activities in which commercial banks may engage are restricted by law and regulation, the first option does not exist fully for commercial banks. Thus, they feel justified in seeking legislative and regulatory relief. Although they are moving rapidly into securities products, the banks would like to perform these services in the most efficient ways, not in second or third best ways. As it is both too late and, I believe, technically impossible to put the genie back in the bottle and prohibit banks from offering a wide range of securities products, efficiency appears to suggest a de jure repeal of much of Glass-Steagall to catch up with the de facto repeal that has already occurred.

On the other hand, opponents argue unfair competition, excessive risk, conflicts of interest, and excessive economic concentration. Most economists now downplay these factors. With the termination of Regulation Q and the ongoing financial problems of the federal deposit insurance agencies pushing up premiums, banks do not appear now, if they ever did, to have an unfair competitive advantage. Thus, the more competition the better. Even if some individual securities activities are risky, the important factor to consider is the interaction of these risks with the banks' existing risks. Although greater

diversification does not by itself guarantee reduced overall risk, it makes it easier for good management to do so. The numerous skeletons of dead and dying banks and particularly thrift institutions that are polluting the landscape today should remind us that poor or risk-seeking managers do not need new powers their damage to perform!

Ironically, the potential for conflicts of interest and economic concentration has been reduced significantly in recent years by the effective removal of the Glass-Steagall imposed barriers to entry into commercial banking. Neither evil can persist for long if easy entry exists to induce competition. This, of course, is not to say that conflicts and concentration will not exist in banking, but only to suggest that they will be no better or worse than in other industries. Securities legislation and regulation adopted since 1933, including disclosure, accounting practices, and consumer protection, should be made applicable to commercial banks to the same extent as to their competitors. Anti-trust laws, whether or not reinforced by special bank merger laws and restrictions on nationwide banking, should be as adequate in preventing excessive concentration in banking as elsewhere. What has been happening in recent years is that, whether or not commercial banking was ever in the past "special", it does not appear to be so today. This implies that for purposes of public policy banking should be treated no differently than any other competitive sector and that any restrictions unique to it should be removed. Much of Glass-

Steagall falls into this category.

I have expanded on many of the ideas in this statement in my longer paper, "Securities Activities of Commercial Banks: Recent Changes in the Economic and Legal Environments", that I submit for the record.

July 31, 1987

SECURITIES ACTIVITIES OF COMMERCIAL BANKS: RECENT CHANGES IN THE ECONOMIC AND LEGAL ENVIRONMENTS

George G. Kaufman
(Loyola University of Chicago)

Paper Prepared to Accompany Statement Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D. C.
August 6, 1987

The Banking Act of 1933, often referred to as the Glass-Steagall Act, was a sweeping and complex piece of legislation. It was enacted in June as a quick, ad hoc fix in reaction to the Great Depression and in particular to the financial holocaust that saw the failure of more than 40 percent of all commercial banks in the United States, the complete closing of all banks for one week immediately after the inauguration of President Roosevelt in March, and a pervasive public attitude of fear and uncertainty about the future of the financial system if not of the entire economic system. It was one of the bills hurriedly

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An earlier draft of this paper was prepared for a conference on "Future Directions in the Financial Services Industry", Georgetown University Law School, Washington, D.C., March 5-6, 1987. Sections of the paper are included in a longer paper, "The Securities Activities of Commercial Banks: The Current Economic and Legal Environment" by the author and Larry Mote, Staff Memoranda (Federal Reserve Bank of Chicago), August 1987.

enacted in the now fabled hectic first one hundred days of the Roosevelt administration. The Act was intended to demonstrate that Congress and the Administration were alert to the crisis and were willing to take strong action to correct perceived weaknesses.

Blame for the crisis was put on a number of forces that had disturbed individual members of Congress for many years. Some of the congressmen had previously introduced legislation to correct these perceived weaknesses, but they had been unable to enact them. Instead, the proposals were lying around waiting for their day in the sun. And the Great Depression brought it, as the public searched for readily identifiable causes and quick solutions. Thus, the Act placed the blame on a poorly organized Federal Reserve System, excessive competition among commercial banks, excessive risk taking by commercial banks, excessive channeling of credit into "speculative, nonproductive" sectors, loss of faith in the banking system, and serious conflict of interest abuses.[1] Among other things, the Act:

1. reorganized the Federal Reserve System,
2. prohibited interest payments on demand deposits,
3. imposed ceilings on interest rates payable on time deposits (Regulation Q),
4. restricted entry of new banks,
5. imposed margin requirements on bank financed securities purchases,
6. introduced federal deposit insurance,

7. expanded national bank intrastate branching powers, and
8. separated full-service commercial and investment banking.

Proposals for restricting bank deposit rates and federal deposit insurance had been frequently introduced in Congress for many years before the Great Depression. Separation of commercial and investment banking had been a pet proposal of Senator Carter Glass throughout the 1920s. Glass, who was also the main author of the Federal Reserve Act in 1913, firmly believed that bank safety could only be achieved if the banks restricted their lending to short-term financing of goods in the production process. Until the 1930s, none of these proposals had gained sufficient support in Congress to advance much beyond the introduction stage. But they were on the shelf! When the crisis struck and legislators were scurrying about to put together a comprehensive package, these proposals were handy and came off the shelf. They found increased support on their own merits and even greater support as a result of horse-trading among supporters of each proposal as part of a comprehensive package. As a result, the Act contains apparently conflicting provisions, such as providing federal deposit insurance to protect smaller unit banks and expanding the branching powers of larger, national banks.

Because most of the individual proposals focused on increasing bank safety by decreasing competition in a particular area, the Act, taken as a whole, was blatantly anti-competitive.

Support for the bill came from the many of the groups to be protected. Once in place, these restrictions gained continued support from powerful groups who benefited from their enactment. Because of the combined effects of a relatively stable, and, in the first years, depressed economy that was not greatly impacted by the restrictions and of relatively unsophisticated information processing computer technology that made circumvention of the restrictions slow and costly, the cost of the restrictions in reduced efficiency to economic welfare and eventually to the banking industry itself was not recognized until many years later when these conditions had changed.

Starting in the late 1960s, however, increased variability in both the rate of inflation and interest rates and advances in computer and telecommunications technology provided both the incentives and the means for circumventing the restrictions imposed by the Act. The commercial banking sector became progressively disadvantaged relative to other sectors that could offer similar products with fewer restrictions. Although many individual banks prospered, the banking industry as a whole suffered a decline in both growth and profitability. Today, there is general agreement among economists that most, if not all, of the restrictions imposed by the Banking Act no longer are necessary, if they ever were, at least for restricting risk. Indeed, by reducing the potential for risk reduction through diversification, the securities restrictions may be counterproductive. Easier entry into commercial banking by both

domestic and foreign entities also reduces the need to be concerned with either excessive economic and political concentration or conflicts of interest, the other two major public policy reasons for the enactment of the financial institution restructuring parts of the Banking Act.[2] The remainder of this paper will focus on recent developments affecting the separation of commercial and investment banking.

II

Commercial banks were initially chartered by governments to grant exclusive rights for issuing notes of circulation. In exchange, the banks were restricted in their permissible activities. Not infrequently, at least in the United States and United Kingdom, they were prohibited from underwriting and investing in longer-term private securities. Thus, different entities were organized to assist private firms in raising longer-term capital. Because these firms did not issue notes, they did not require commercial bank charters. To service their customers, these entities, which generally went by the name of merchant, investment or private bank, began to offer deposit accounts, which was not an important service of commercial banks at the time.

In the mid-1800s, deposit banking expanded in importance in the United States and these services were increasingly offered by commercial banks, all of which were state chartered. At the same time, the banks obtained increasing powers to offer securities

activities in competition with private banks. After the National Bank Act of 1865 established note-issuing national banks and taxed state banks out of note issuance, state banks assumed almost complete securities powers.[3] Although the history appears to be particularly murky in this area, it appears that, at first, national banks were permitted to underwrite and deal in securities in which they were permitted to invest, which were primarily those of the federal government and municipalities. In time, this authority was extended to corporate bonds and then to corporate equities to keep the national banks on an equal footing with state banks.[4]

At the turn of the twentieth century, national banks were forced to transfer their securities activities to securities affiliates which, unlike their parent banks, could have offices in any state. The McFadden Act of 1927 gave national banks themselves complete parity in securities activities with state banks and by 1930, commercial banks in total underwrote about 70 percent of the dollar volume of new securities. The complete fusion of full-service commercial and investment banking was short-lived, however, ending with the Glass-Steagall separation in 1933 for commercial banks that are members of the Federal Reserve System.

But the Glass-Steagall Act separation was not complete nor intended to be complete. From the beginning, commercial banks were explicitly permitted to underwrite and trade U.S. Treasury securities and municipal general obligation securities, assist in

customer merger and acquisition, and provide financial advice and counseling. The status of other securities activities was not clearly spelled out in the Act, particularly if underwriting and trading were conducted through affiliates.[5] Thus, the legal ability of the banks in many areas was open to the interpretation of the banks, the regulatory agencies, the courts, and Congress, as the final arbitrator.

Immediately after the enactment of Glass-Steagall, there was little demand for new private securities and commercial banks did not test the constraints. Indeed, between 1929 and 1952, assets of security dealers and brokers actually declined by 60 percent. This was the largest decline of any of the 24 financial intermediaries analyzed by Raymond Goldsmith in his study of U.S. financial intermediaries in the twentieth century and security firms were one of only four intermediaries that experienced a decline in this period.[6] In contrast, assets at commercial banks nearly tripled in this period. Nor had security firms done much better over the longer 1900-1952 period. Their assets expanded by a factor of six in this period, only one-third that of commercial banks.[7]

But things started changing after the early post-World War II period as the demand for non-explicitly permitted securities, such as municipal revenue bonds and corporate securities, increased. At first, the attempts by commercial banks to expand their activities in these areas were rebuffed by reluctant regulatory agencies (except the Comptroller of the Currency after

1960) and courts, and the growth in bank securities activities was slow.[8] In more recent years, however, the growth in both the range and volume of domestic securities activities conducted by commercial banks, particularly larger banks, has accelerated sharply. This acceleration appears to reflect at least four new forces:

1. Increases in information processing and communications technology that have reduced these costs sharply and have provided hopes of significant economies of scope in offering expanded securities activities alongside the banks' currently permissible deposit, lending, and securities activities through the use of largely in-place personnel and equipment,

2. A search for new activities as profits from permitted commercial banking activities have declined, particularly from lending to high quality large corporations, many of whom are finding it cheaper to sell their own commercial paper as technology has increased the availability and reduced the cost of credit information and analysis to the public thereby eroding the commercial banks' historical comparative advantage in this area,

3. Perceived rapid growth and large profits in full-service securities activities as the volume and complexity of securities have both increased sharply, and

4. More liberal interpretations of the language of the Glass-Steagall legislation by both the bank regulatory agencies and the courts.

5. Growing internationalization of financial markets that has provided U.S. banks with experience in securities activities in many foreign countries and intensified competition with foreign banks and foreign markets.

In previous articles, I have chronicled the progress of banks in expanding their securities activities through 1984, including the watershed acquisition of Schwab Discount Brokers by BankAmerica in 1981.[9] At that time, I concluded that

> it would appear that the limitations on commercial banks' activities in providing securities and ancillary services are to a large extent the fault of the banks themselves. They were inhibited, for good or for bad reasons, as much by internal, self-imposed constraints (including lack of imagination) as by external constraints.... While enactment of sweeping new banking legislation is improbable, a continued nibbling away of the elements of separateness between commercial banking and investment banking does seem likely.... Indeed, it is not too farfetched to predict that Glass-Steagall will be no more effective in maintaining a separation between commercial and investment banking in a few years than the McFadden Act and the Douglas Amendment...have been in preventing interstate banking.[10]

I see no reason to change my conclusions at this time. This paper describes and analyzes the major changes in securities activities offered by commercial banks since the last survey in 1984 through mid-1987, discusses the implications of these changes for the efficiency and safety of both commercial banks and the financial system, and examines the remaining public policy issues.

III

The increased bank securities activities since 1984 do not reflect new permissive federal legislation. Rather they reflect

1) greater volume of activities specifically permitted in 1984 or not explicitly prohibited and sustained by the courts since 1984, 2) new activities that were neither provided by the banks nor prohibited to the banks in 1984, and 3) new activities permitted by regulation since 1984.

Favorable court rulings have continued to permit 1) national banks to provide brokerage services at out-of-state offices, 2) all commercial bank affiliated brokerage personnel and units to be supervised by the bank regulatory agencies rather than the Securities and Exchange Commission, 3) all banks to place commercial paper privately in an agency capacity and 4) commercial banks to commingle IRA funds for both investment and advertising purposes.[11] Favorable regulatory rulings since 1984, primarily from the Board of Governors of the Federal Reserve System, have reinforced the banks' abilities to place commercial paper privately and, more recently, permitted them to underwrite and trade third-party commercial paper, all municipal revenue bonds, mortgaged-backed securities, and consumer paper-backed securities and to provide integrated brokerage services and investment advice to institutional investors.[12]

The Board's series of rulings since December 1986 permitting banking organizations to underwrite and deal in a broad range of debt securities that are prohibited to the banks themselves by Section 16 of the Glass-Steagall Act are of particular importance. The decisions are based on the Board's interpretation of Section 20 of the Act which prohibits member

banks from being "affiliated in any manner ... with any corporation ... engaged primarily in the issue ... underwriting, public issue ... of stocks, bonds, debentures, notes, or other securities." [Author's underscoring.] On the basis of the words "engaged primarily", the Board concluded that "Section 20 by its terms does not require this separation [commercial and investment banking] to be complete".[13] The securities activities not explicitly permitted commercial banks themselves by the Act, however, must be performed in an affiliate. To insure that the affiliate does not engage primarily in prohibited securities, the Board imposed limitations on the affiliate's activities in the areas in terms of the relative magnitudes of the activity per se and of the affiliate's business. For the time being, subject to later review, the Board defined "primarily" as no more than 5 percent of the market for the security and 5 percent of gross revenues for the affiliate.

In contrast to the unanimous vote on approving the new activities, the Board was split in some of the rulings in determining the base to which these restrictions should be applied. The majority believe that explicitly eligible securities for banks, e.g., U.S. Treasury and federal agency securities, are not included as securities in the "engaged primarily" proviso of Section 20 of the Glass-Steagall Act and that the base could, therefore, be the dollar volume of all securities activities conducted by the affiliate. As activities in explicitly eligible securities are large for many banks'

securities affiliates, this interpretation permits a relatively large volume of new activities.

The minority of the Board, including Chairman Volcker, do not interpret the Act as excluding explicitly permitted securities from the definition of securities in the "engaged primarily" proviso of Section 20. Thus, affiliates engaged primarily in underwriting and dealing in explicitly permitted securities cannot also engage in underwriting and dealing in the not explicitly permitted securities. The new activities must be carried out in different affiliates. This reduces the relevant gross revenue base and reduces a bank's potential operations in these activities substantially. This interpretation would also limit the existing securities firms that a banking organization could acquire.[14]

The Board's approvals activated the automatic reflex court challenge by the Securities Industry Association (often in conjunction with the Investment Companies Institute). In contrast to most of its previous attempts, which were unsuccessful, the SIA was successful in 1987 in obtaining a temporary stay from the U.S. Court of Appeals for the Second District on some of the Fed's 1987 rulings on new securities activities. Similar to the two Board dissenters, the SIA argued that explicitly eligible securities are securities for purposes of the Glass-Steagall Act and need to be included in the "engaged primarily" proviso of Section 20. At the same time, a number of

banks that were granted the new securities powers by the Board sued the Board to have the volume restrictions eased.[15]

After years of legislative inaction on the issue, the Board's actions, combined with a number of other recent events affecting the competitive relationship of commercial banks and their nonbank competitors, motivated Congress to take another look at bank powers in general. In order to gain additional time for this review, the House and Senate Banking committees agreed to a moratorium on new securities powers through March 1, 1988, with a proviso that the moratorium cannot be renewed. Thus, Congress appears to be making a belated last-ditch attempt to regain control over bank powers from the regulatory agencies and the Courts. Based on recent experience, the likelihood for lasting success is questionable.

Until the issue is clearly resolved, which is unlikely as legislative language is unclear and ambiguous almost by definition, the banks may reasonably be expected to continue to explore around the edges of Glass-Steagall to discover additional possibilities, particularly through the "engaged principally" provision for affiliates.

In addition, the FDIC and New York State have authorized broader securities activities through affiliates for banks under their jurisdiction. Because most commercial banks that are in a position to provide securities services seriously are either members of the Federal reserve or affiliates of bank holding companies, all of which are subject to Federal Reserve

jurisdiction, the FDIC and New York actions represent more smoke than fire. However, they may be useful in sending smoke signals to other regulatory and legislative bodies. A few large banks have added to the strength of these signals by discussing openly the possibilities of changing or even surrendering altogether their commercial bank charters.[16] Most if not all of these liberal regulatory rulings have been in response to continued search by banks for new inroads into the securities area that do not hit the Glass-Steagall prohibitions head on. The keys for success in this venture remain imagination on the part of commercial banks and willingness to expand the financial and managerial efforts to fight the particular activity through regulatory and legislative barriers.

Most of the increased securities action in dollar terms appears to be in the expansion of recently entered or newly discovered activities. Perhaps the most important is the expansion of brokerage activities. In this area, banks may serve institutions as well as individuals. But, because they are unable to hold inventories of large menus of securities and thereby to have a supply of securities on hand to offer investors immediately or to be in a position to purchase securities from customers immediately, commercial banks had viewed themselves as at a disadvantage to security dealers in serving institutional customers. However, some larger banks have found ways around this disadvantage. Banks can broker securities for pension, mutual, and other large funds, including those that are managed

by their own trust departments or other affiliated entities.[17] These funds have continuing orders for securities that they wish to purchase for or sell out of their portfolios. By channeling these transactions through the bank's brokerage facility, the broker is effectively provided with an inventory that serves as a partial equivalent to, at least, the ready market aspect of a full-service dealer. However, the broker would not be able to participate in any gains (or losses) from positioning securities in inventory.

Moreover, a number of the largest banks have established brokerage and dealer facilities in major foreign countries. In the process, they have developed execution and research capabilities in foreign securities that they can offer their clients in the U.S.[18] Citicorp affiliates overseas are reported to be members of 17 major stock exchanges in foreign countries and to regularly research some 800 foreign stocks that account for 70 percent of the aggregate capitalization of the stocks traded on these exchanges. In addition, Citicorp has investment banking offices in over 45 foreign countries and some banking presence in over 90 foreign countries.[19] Such worldwide brokerage is a service that few if any domestic security dealers can offer domestic customers to the same extent as these banks can. Indeed, in a recent full two-page advertisement in the Wall Street Journal, the Chase Manhattan Bank compared its international presence, particularly in merger and acquisition

activities, with that of ten major investment banks. (Exhibit 1) It stated

> With offices in 60 countries around the world, Chase has greater international presence than any U.S. investment bank. In fact, Chase has offices in almost twice as many countries as the above ten investment banks combined.[20]

Overall, the Federal Reserve has identified more than 30 major investment subsidiaries of U.S. banking organizations operating in foreign countries; 12 in the United Kingdom alone. In 1985, overseas affiliates of five U.S. commercial banks were among the top 30 leading managers of Eurobond underwriters and 11 were among the top 50 of Euronote underwriters.[21] With the rapid growth in interest by U.S. institutions in overseas securities and markets, large commercial banks are uniquely positioned to capture a large share of the business.

Commercial banks have also exploited the ability to effectively circumvent most Glass-Steagall and other powers prohibitions by entering into joint venture-like arrangements in which the other party undertakes the activity specifically prohibited commercial banks. For example, Glass-Steagall prohibits commercial banks from sponsoring and selling mutual funds, other than those associated with servicing IRAs. This activity is properly viewed as engaging in the public sale of securities. But the Act does not prohibit banks from managing such funds and this activity has been specifically authorized by regulation. And managing funds is where the money generally is! As a result, an increasing number of banks have entered into

TABLE 2

Nonpermissible Domestic Commercial Bank Securities Activities[1, 2]
July 1987

Underwriting, Distributing, and Dealing

Corporate bonds

Corporate equities

Mutual Funds Underwriting and Distributing

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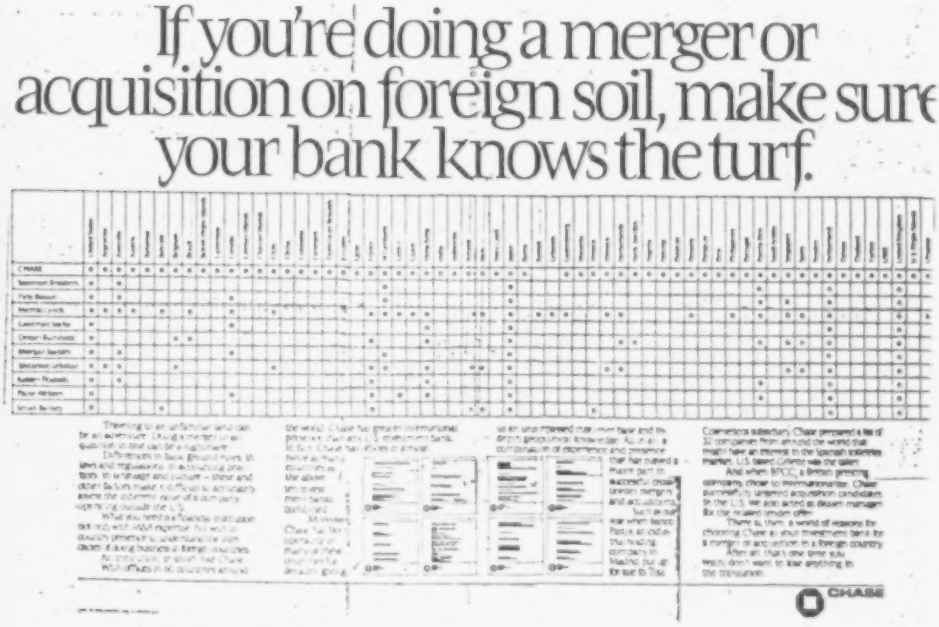
1 Federal Reserve member banks and bank holding company affiliates.
2 Excluding implications of Congressional moratorium if enacted. (See Table 1)

EXHIBIT 1



Wall Street Journal, Thursday, May 21, 1987

 EXHIBIT 2

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FIRST CHICAGO
The First National Bank of Chicago

Dreyfus GNMA Fund

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Yes, please send me information on the following Fund(s)

_____

☐ Please send me an IRA Kit

Name _____

Address _____

City _____ State _____ Zip _____

For more information call toll free

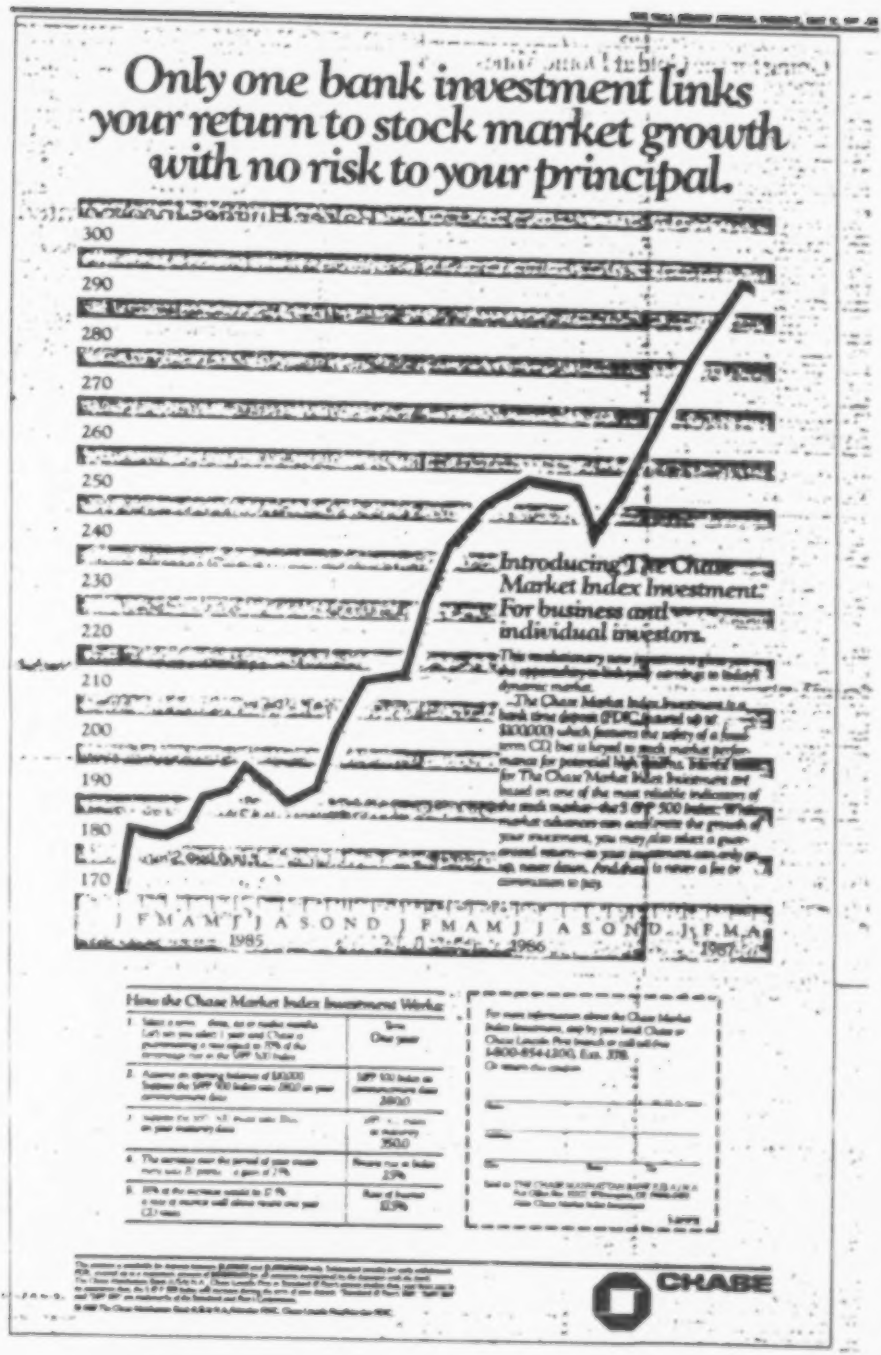
1-800-821-1185

8am–7pm Weekdays
9am–5pm Sundays

Both Funds are distributed by Dreyfus Service Corporation

Chicago Tribune, Thursday, April 9, 1987.

EXHIBIT 3



Wall Street Journal, Tuesday, May 26, 1987.

FOOTNOTES

1. Carter H. Golembe, "The Deposit Insurance Legislation of 1933: An Examination of Its Antecedents and Its Purpose", Political Science Quarterly, June 1960, pp. 181-200; H. Parker Willis and John M. Chapman, The Banking Situation (New York: Columbia University Press, 1934); Federal Deposit Insurance Corporation, The First Fifty Years: A History of the FDIC, 1933-1983 (Washington, D.C., 1984).

2. A more detailed examination of the concentration and conflicts of interest issues appears in George G. Kaufman and Larry R. Mote, "Securities Activities of Commercial Banks: The Current Legal and Economic Environment", Staff Memoranda (Federal Reserve Bank of Chicago), August 1987.

3. Ross M. Robertson, The Comptroller and Bank Supervision: A Historical Appraisal (Washington, D.C.: Office of the Comptroller of the Currency, 1968), pp. 21-23; George G. Kaufman, "The Securities Activities of Commercial Banks", in Richard Aspinwall and Robert Eisenbeis, eds., Handbook for Banking Strategy (New York: John Wiley & Sons, 1985), pp. 661-702,

4. U.S. Department of the Treasury, Public Policy Aspects of Bank Securities Activities, reprinted in U.S. Congress, Senate, Committee on Banking, Housing, and Urban Affairs, Securities Activities of Commercial Banks: Hearings, December 9-10, 1975, pp. 22-87.

5. Board of Governors of the Federal Reserve System, "Bankers Trust New York Corporation, New York, New York: Order Approving Application to Engage in Commercial Paper Placement to a Limited Extent", Federal Reserve Bulletin, February 1987, pp. 138-154.

6. Raymond W. Goldsmith, Financial Intermediaries in the American Economy Since 1900. Princeton, N.J.: Princeton University Press, 1958, p. 80.

7. Ibid, p. 69.

8. In 1968, Congress expanded the list of securities eligible for dealing by commercial banks to include municipal revenue bonds issued for housing, university, and dormitory purposes.

9. Kaufman, "The Securities Activities...."; George G. Kaufman, "The Securities Activities of Banks: What Has Been Done and What Could Have Been Done", Proceedings of a Conference on Bank Structure and Competition (Federal Reserve Bank of Chicago), April 1984, pp. 202-210; and Thomas G. Fischer,

William H. Gram, George G. Kaufman, and Larry R. Mote, "The Securities Activities of Commercial Banks: A Legal and Economic Analysis", Tennessee Law Review, Spring 1984, pp. 467-578.

10. Kaufman, "The Securities Activities....", pp. 696-698.

11. "Combining IRAs", Wall Street Journal, November 4, 1986, p. 4; Jane Bryant Quinn, "The Duel for Your IRA", Newsweek, March 30, 1987, pp. 55; Robert M. Garsson, "High Court: Banks Can Deal in Commercial Paper", American Banker, June 23, 1987, pp. 1, 14.

12. Board of Governors of the Federal Reserve System, "National Westminster Bank PLC, London England; Order Approving Application to Engage in Combined Investment Advisory and Securities Execution Services", Federal Reserve Bulletin, August 1986, pp. 584-596; Board of Governors of the Federal Reserve System, "Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities", Federal Reserve Bulletin, June 1987, pp. 473-510; Jed Horowitz, "Court Upholds Move By Banks Into Brokerage", American Banker, July 8, 1987, pp. 1, 22; John E. Yang and Phillip L. Zweig, "Bankers Trust Gets Additional Fed Clearance", Wall Street Journal, December 26, 1986, p. 3; John E. Yang, "Fed Lets Chase Underwrite, Trade Commercial Paper", Wall Street Journal, March 19, 1987, p. 2; John E. Yang, "Fed Vote on Banks' Securities Dealing Blurs Legal Line", Wall Street Journal, May 1, 1987, p. 26; Nathaniel C. Nash, "Bank Curb Eased in Volcker Defeat", New York Times, May 1, 1987, pp. 25, 37; Jed Horowitz, "Fed's Ruling Not Clear-Cut Bank Victory", American Banker, May 4, 1987, pp. 1, 31; John E. Yang, "Fed Votes to Give 7 Bank Holding Firms Additional Securities Powers in Securities Sector", Wall Street Journal, July 16, 1987, p. 2; Jed Horowitz, "Fed Gives Banks Powers to Deal in Receivables", American Banker, July 16, 1987; Barbara A. Rehm, "Fed to Permit Chase to Work Mortgage Issues", American Banker, July 21, 1987, pp. 1, 23.

13. Board of Governors, "Bankers Trust Order", p. 141.

14. Board of Governors, "Limited Underwriting and Dealing Order", p. 505.

15. Jed Horowitz, "Banks, Brokers Clash in Court on Underwriting", American Banker, June 24, 1987, pp. 3, 31.

16. Monica Langley, "U.S. Regulators Move to Let Banks Enter Several New Businesses", Wall Street Journal, December 29, 1986, p. 1.

agreements with investment companies to create new private label mutual funds that will be managed by the bank, advertised by the bank, but sold and bought by the investment company. Advertisements for such mutual funds are now relatively common. (Exhibit 2) Other banks broker outside managed mutual funds for a sales commission. A recent survey of larger banks reported that nearly 70 percent of the banks offered mutual funds in one form or another in 1986.[22] This represented a 50 percent increase over 1985. In addition, another 15 percent planned to offer mutual funds in the near future. Some banks offered funds only to IRA customers. Most funds were offered through the banks' discount brokers.

A unique and highly sophisticated securities product was recently introduced by the Chase Manhattan Bank. This market index investment account is a fixed-term deposit whose return is partially tied to the performance of the S&P 500 stock index. (Exhibit 3) It comes with a choice of three maturities -- 3 months, 6 months, and 1 year -- and three combinations of minimum guaranteed return and percentage participation in increases in the stock market index. For example, on the one year account, the depositor may choose a zero guaranteed minimum return and 70 percent of the increase in the S&P index over the year, a 2 percent guaranteed minimum return and 60 percent of the index increase, or a 4 percent guaranteed minimum return and 40 percent of the index increase.[23] Thus, the total return on these accounts is not known until maturity. As a deposit, its

principal amount is fixed and is insured up to $100,000 by the FDIC.

Economically, Chase's new market index investment account differs in only two significant ways from an indexed stock mutual fund account. One, it has a fixed maturity or redemption date (although early redemptions are permitted with penalty of loss of all interest and part of the principal). Two, it has a guaranteed floor if the market index declines or increases by less than the floor percentage. The cost of this downside protection to the investor is reduced upside participation in increases in the index return above the minimum guarantee. In this way, the account resembles a mutual fund account with an embedded European put option that can be exercised by the investor at maturity at the guaranteed floor value.

To reduce its portfolio risk from this account, the Chase invests partially in S&P 500 index futures contracts.[24] Banks and bank affiliates are permitted to invest in these futures contracts for their own accounts because the contracts are settled only in cash, not in stocks. Thus, they are not considered equity securities by the regulatory agencies for purposes of Glass-Steagall. Except for the use of future contracts instead of the underlying equities themselves, Chase's operations in both distributing and managing this account is not greatly different from that of any mutual fund. Not surprisingly, the Investment Companies Institute has filed a suit charging violation of the Glass-Steagall Act. Unless denied by

the courts, deposit accounts of this type can provide commercial banks with a highly competitive product to mutual funds. Indeed,it basically differs from a mutual fund product in name only, and demonstrates clearly how the combination of imagination and nerve can effectively circumvent the constraints of Glass-Steagall.

Bank brokers can also participate in the sale of newly underwritten securities with the broker's name even appearing on the issue tombstone alongside the actual underwriters (although in a lower bracket to conform with the traditional pecking order in investment banking and clearly identified as a broker). The bank broker provides the underwriters with a list of potential buyers from among its own customers and processes orders from these and possibly other buyers for a commission per transaction. The first such cooperative venture appears to have been between BankAmerica's Schwab brokerage affiliate and Lazard Freres in 1986.[25] Joint ventures have also been pursued in prohibited non-securities activities, such as insurance and real estate brokerage.

The current status of what commercial banks that are members of the Federal Reserve System may or may not do in the securities arena is shown in Tables 1 and 2, respectively. The commercial banks appear to be able to participate in activities that currently account for more than 50 percent of the gross revenues of all securities firms and are able to underwrite close to 80 percent of the dollar amount of all new securities.

The drive for expanded securities powers is not being pursued equally vigorously by all banks. The leaders in the battle are primarily the larger banks, who may be expected to make the greatest absolute and relative use of any new powers granted. But it is far from certain that all larger banks will find the new activities profitable. For a number of reasons, many will find the returns realized to be well below those expected. A large number of securities activities are highly entrepreneurial in nature and attract players who can expect and command remuneration that is extraordinarily high relative to that in other, more traditional bank activities. This puts many banks in a quandary. If they do not meet the compensation demand, the more successful personnel may leave for investment banking houses; if they do, jealousies may arise in other parts of the bank that could adversely affect efficiency and morale. Both patterns have occurred in recent years. Investment banking appears to have a substantially different corporate culture than commercial banking, and the two may not mix easily or peacefully.[26]

Moreover, investment banking appears to be a highly competitive industry and entry is, at least, legally easy for everyone other than commercial banks. For these potential entrants, the major barrier appears to be human resources. To the extent that these resources can be found reasonably quickly, profits that may appear excessive currently will not be excessive through time. Indeed, it is unlikely that most commercial banks

would find full-service investment banking very profitable if permitted. A recent article in the American Banker speculated that perhaps only a few could compete across-the-board successfully. Morgan Guaranty, Bankers Trust, and possibly Citicorp appear to be profitable in their current broad investment banking activities.[27] Many more commercial banks are likely to be successful in more limited securities areas by selecting their niches carefully.

Ironically, it may well be regional and even some smaller banks, banks that have generally not been active in agitating for additional securities powers, that may eventually be among the more successful. Major investment banking activity is concentrated in the larger cities and services best larger clients. Smaller firms and smaller government units, particularly in smaller cities, may be less well served. Investment banks have few offices in smaller cities and those that are there are mostly retail offices. Nonretail securities services in these areas are generally conducted from distant offices. In contrast, commercial banks tend to have more decision-making personnel at their local offices, even if they are only branch offices. Banks in these areas that have good ongoing relationships with a broad base of customers may be able to make significant inroads into the competing investment bankers territories.[28]

IV

In sum, where does the Glass-Steagall controversy stand now and where is it likely to go in the near future? The answer is not greatly different than three years ago. The forces of the market are breaching the ramparts of Act, weakening its deterrent capabilities. Banks are becoming progressively more aggressive in searching out potentially profitable additional securities activities and designing means by which they can be provided without challenging the core of Glass-Steagall head-on. In this process, they are being assisted by the bank regulatory agencies, at first the Comptroller of the Currency and more recently the Board of Governors of the Federal Reserve System, who are responding to the changes in the marketplace by providing more liberal interpretations of the language of the Act. At least recently, the courts have placed substantial weight to the rulings of the agencies when they are argued carefully so they appear to fit within the context of the Act and do not flaunt the novelty of the permitted powers. (This practice may assist the SIA's challenge to the Board's recent rulings on new securities powers in which there were strong minority dissents, including that of the Chairman.) As a result, commercial banks have increased both the volume and range of securities activities substantially within the confines of Glass-Steagall. They are openly advertising their progressively expanded investment banking services and challenging the investment banks and mutual funds head on. And so it probably will continue with both the

banks and, particularly, the regulatory agencies becoming more aggressive.

A major de jure dismantling or, despite the possibility of a moratorium on some new securities powers, a reinforcement of Glass-Steagall by Congress in the next few years is unlikely. Such changes generally occur only at times of major financial crisis or loud public outcry. Neither event is likely soon. Although frequently introduced in recent years, more limited liberalizations of the Act have, with infrequent exception, not yet made it past both houses of Congress. Because the market place and, in the absence of a moratorium, the regulatory agencies are jointly dismantling the Act de facto bit by bit, neither outright repeal nor major modifications are as necessary as they once were. Nevertheless, many of the additional powers are forced to be provided in a less than the most efficient form, with some deadweight loss to society. For this reason as well as for aesthetic reasons in general, a major legislative review and de jure modernization of Glass-Steagall remains desirable for purposes of public policy.

TABLE 1

Permissible Domestic Commercial Bank Securities Activities[1]
July 1987

	Year Started[2]
Underwriting, Distributing, and Dealing	
U.S. Treasury securities	Always
U.S. federal agency securities	Various years
Commercial paper (third party)	1987[3]
Mortgage and consumer paper backed securities	1987[3]
Municipal securities	
General obligation	Nearly always
Some revenue bonds	1968
All revenue bonds	1987[3]
Financial and precious metal futures brokerage and dealing	1983[4]
Private Placement (Agency Capacity)	Always
Sponsor Closed-End Funds	1974
Underwrite Deposits with Returns Tied Partially to Stock Market Performance	1987
Offshore Dealing in Eurodollar Securities	Always
Mergers and Acquisitions	Always
Trust Investments	
Individual accounts	Always
IRA commingled accounts	1982
Automatic Investment Service	1974
Dividend Investment Service	Always
Financial Advising and Managing	
Closed-end funds	1974
Mutual funds	1974
Restricted	Always
Brokerage	
Limited customer	Always
Public retail (discount)	1982
Securities Swapping	Always
Research Advice to Investors	
Separate from brokerage	1983
Combined with brokerage (institutional)	1986

1 Federal Reserve member banks and bank holding company affiliates

2 Regulatory rulings frequently concluded that specific activity was permissible before date of ruling. If activity halted by enactment of Glass-Steagall Act, date of renewed activity.

3 Generally subject to stay pending outcome of court challenge and to possible Congressional moratorium.

4 Restricted to futures contracts for which banks may hold the underlying security or that are settled only in cash.

17. Saul Hansell, "Don't Look Now, But That Broker is a Bank", Institutional Investor, February 1987, pp. 173-175.

18. E. S. Ely, "Dawn of a New Age", Institutional Investor, March 1987, pp. 245-255.

19. George G. Kaufman, The U.S. Financial System: Money, Markets, and Institutions, 3rd ed. (Englewood Cliffs, N.J.: Prentice Hall, 1986), pp. 172-173.

20. Chase Manhattan Bank, "If You're Doing a Merger or Acquisition on Foreign Soil, Make Sure Your Bank Knows the Turf", Wall Street Journal, May 21, 1987, pp. 12-13.

21. "Appendices to the Statement by Paul A. Volcker" in U.S. Congress, House of Representatives, Subcommittee on Commerce, Consumer, and Monetary Affairs of Committee on Government Operations, Structure and Regulation of Financial Firms and Holding Companies: Hearings (Part 1), April 22, June 11 and July 28, 1986, pp. 452-454.

22. "More Banks Offer Mutual Funds to Customers", American Banker, November 3, 1986, p. 14.Preliminary results of a more recent survey by the Bank Administration Institute of banks between $1 and $5 billion in asset size found a somewhat higher percentage. The survey also found that about 85 percent of these banks engaged in some type of securities brokerage.

23. Market Index Investment Information Booklet, Chase Manhattan Bank, n.d.

24. Citibank is test marketing a similar stock-linked deposit account. Gary Weiss, "Chase Chases the Stock Runup -- And Big Investors", Business Week, June 8, 1987, p. 115; John Whitelaw, "Chase Shelves Index-Note Plan, Citing Tepid Investor Response", American Banker, July 30, 1987, pp. 2, 67.

25. Steve Swartz and Monica Langley, "BankAmerica Unit Plans Role in Underwriting", Wall Street Journal, September 24, 1986, p. 4. Details of this arrangement appear in Bevis Longstreth, "Testimony" in U.S. Congress, House of Representatives, Subcommittee on Commerce, Consumer, and Monetary Affairs of Committee on Government Operations, Structure and Regulation of Financial Firms and Holding Companies: Hearings (Part 3), December 17-18, 1986, p. 197.

26. Suzanna Andrews, "Mutiny at the Banks", Institutional Investor, August 1985, pp. 115-126; Sarah Bartlett, "Is This Any Way to Run an Investment Bank? Citicorp Thinks So", Business Week, July 28, 1986, pp. 56-58; Philip L. Zweig, "Some Big Banks Find Entering New Fields A Tough

Transition", Wall Street Journal, August 13, 1986, pp. 1, 16.

27. Andrew Alber, "Few Win at Investment Banking, But Biggest Institutions Are Making Inroads", American Banker, July 21, 1986, p. 9. For evidence that nonbanks also do not find entry into financial services necessarily easy or successful, see Steve Swartz and Steve Weiner, "Many Firms Back Off From Offering Arrays of Financial Services", Wall Street Journal, November 12, 1986, pp. 1, 28.

28. Small investment banks are also able to compete with bigger investment banks. Patricia B. Gray, "How Small Firms Given Big Investment Banks A Run For Their Money", Wall Street Journal, July 29, 1986, pp. 1, 19.

The CHAIRMAN. Thank you, sir.

Our next witness is Alan Fox, who is a representative of Consumer Federation of America. Go ahead, Mr. Fox.

STATEMENT OF ALAN FOX, LEGISLATIVE REPRESENTATIVE, CONSUMER FEDERATION OF AMERICA

Mr. Fox. Thank you very much, Mr. Chairman and members of the committee. I am Alan Fox, legislative representative for Consumer Federation of America, which consists of over 230 local, State and national consumer, senior citizen, rural, cooperative, and labor organizations that together have over 50 million members. I want to begin by making clear that CFA has not conducted any specific studies and has no specific information on the costs or benefits to consumers of bank holding company underwriting of mutual funds.

What I'd like to present instead are some principles which we believe should be in the minds of Members of the Senate and the House as these issues are looked at and some of the implications of those principles for consideration of bank holding company underwriting of mutual funds and, indeed, for other proposed expansions of bank holding company powers.

Unfortunately, the issue is not a simple question of removing barriers, increasing competition, and allowing more entrants into the marketplace. If that were the only issue, then there would probably be no need for these hearings and these restrictions would have been removed long ago.

Bank holding company underwriting of mutual funds raises a fundamental issue about the role of banks and banking. It's a question of how banks are to serve the communities in which they operate and how they define those communities.

Banks are unique businesses. They are chartered to serve the convenience and needs of the public—the entire public. They are protected by a deposit insurance system. That deposit insurance system wasn't created by competitive forces or by the marketplace. It was mandated by the people of the United States acting through their representatives in Congress and it's a system maintained with the explicit backing of the public of the United States.

Even before then, the Supreme Court ruled in 1896 that national banks are created for a public purpose. That ruling has been referred to by a variety of court decisions in the more than 90 years since 1896. So one of the questions before Congress in consideration of bank holding company underwriting of mutual funds is a question of how that public purpose will be fulfilled and how it will be fulfilled directly by permitting bank holding company entry.

LITTLE BENEFIT FOR THE PUBLIC

Unfortunately, few in the public will benefit directly from bank holding company underwriting of mutual funds. Asset holdings in the United States are very highly concentrated, more highly concentrated than family income, according to studies conducted by the Federal Reserve Board.

According to the mutual fund industry, the Investment Company Institute's most recent fact book, the median household income of

mutual fund shareholders in 1986 was $46,400. That's a figure that's nearly twice the median income of all American families.

So who is going to benefit from bank holding company underwriting of mutual funds? Those families with higher incomes will. The question is how the rest of American families will benefit.

I think it's fairly clear that the 39 percent of all American families that have less than $1,000 in total financial assets will not benefit in the least from increased entry into mutual funds by bank holding companies. The consumers that are paying banks steadily increasing fees, fees that are usually if not always triggered by increasingly high balance requirements, are not going to benefit from mutual fund underwriting. And the 21 percent of all consumers that have dropped out or have been pushed out of the banking system will certainly gain nothing unless Congress acts to ensure that their interests are considered.

For all of these consumers, many of whom live from paycheck to paycheck, struggle to save a few dollars a month, access to mutual funds is not the issue. Access to basic banking services is the issue. Most consumers are looking for nothing more than a place to store some funds, a way to pay their bills, and some encouragement to put a few dollars into savings.

Bank holding company underwriting of mutual funds will provide none of these services to most American consumers. It will add an option to those consumers who already have an ample array of choices, but does nothing to fulfill banks' obligations to the communities that they are chartered to serve.

The question is whether the benefit to consumers from bank holding company underwriting will be nonexistent or, at best, the trickle-down benefit that some have suggested, or whether there's a way for Congress to ensure that the benefits are substantial.

I believe that the proposal presents Congress with the opportunity to ensure that banks do meet these obligations to all their consumers. I believe it's appropriate for Congress to declare that mutual fund powers are not a right but a privilege accorded only to those banks that make a full effort to meet the deposit needs of the entire community in which they operate.

Mr. Chairman, we propose that Congress make banks a simple offer. If they want to expand deposit services for the affluent through underwriting mutual funds, they must also provide a minimum level of service for those of modest means. Specifically, we would propose that every bank subsidiary of a holding company that underwrites mutual funds should be required to offer at every one of their banking offices both a minimum passbook or statement savings account that can be opened with a minimal amount of funds and that is not subject to any regular fee or interest rate reduction, and a checking account that can be held by low-balance consumers and is not subject to regular fees if account activity is limited.

By establishing these conditions Congress will help to ensure that the benefits of mutual fund underwriting flow to all consumers and not just to the affluent. Congress will reestablish the principle that banks do serve a public purpose and that fulfillment of that public purpose requires provision of services accessible to the entire community a bank is chartered to serve.

Thank you.

[The complete prepared statement of Alan Fox follows:]

paycheck and struggle to save a few dollars a month, access to mutual funds is not the issue. Access to basic banking services is the issue. Most consumers need nothing more than a place to store their funds, a means for paying bills, and encouragement to put some money into savings.

Bank holding company underwriting of mutual funds provides none of these services to American consumers. Underwriting of mutual funds provides an additional option to those consumers that already have an ample array of choices. Underwriting mutual funds does nothing to fulfill banks' obligations to the communities they are chartered to serve.

The proposal to allow banks mutual fund powers presents Congress with an opportunity, however, to ensure that banks do meet these obligations. It is appropriate for Congress to declare that mutual fund powers are not a right, but a privilege accorded only to those banks that make a full effort to meet the deposit needs of the entire community in which they operate.

Congress should make banks a simple offer: If they want to expand services for the affluent they must also provide a minimum level of service for those of modest means. Specifically, we propose that each bank subsidiary of a holding company that underwrites mutual funds should be required to offer, at every banking office:

*A passbook or statement savings account that may be opened with no more than $5 and that is not subject to any regular fee or interest rate reduction for balances of $50 or more; and

*A checking account that may be opened with no more than $25 and that is not subject to any regular fee if account activity is limited to no fewer than six checks per month and two deposits per month at a staffed teller window, with no limits on ATM access.

By establishing these conditions, Congress will help to ensure that the benefits of mutual fund underwriting flow to all consumers, not just to the affluent. Congress will reestablish the principle that banks do serve a public purpose, and that fulfillment of that public purpose requires provision of services accessible to the entire community a bank is chartered to serve.

The CHAIRMAN. Thank you, Mr. Fox.

Our next witness is Stan Sabin, chairman of the Real Estate Committee of the National Association of Realtors. We're happy to have you, sir. Go right ahead.

STATEMENT OF STAN H. SABIN, CHAIR, REAL ESTATE FINANCE COMMITTEE, NATIONAL ASSOCIATION OF REALTORS

Mr. SABIN. Thank you, Mr. Chairman, my name is Stan H. Sabin. I am a realtor from Huntington Beach, CA and the 1987 chair of the Real Estate Finance Committee of the National Association of Realtors.

On behalf of the more than 730,000 members of the association, I want to thank you for the opportunity to present our views on the subject of bank holding company underwriting of mortgage-backed securities.

MORTGAGE-BACKED SECURITIES

Mr. Chairman, we are testifying on this issue today because any expansion in the mortgage securities market has an impact on the increasingly important secondary mortgage market. The development of the secondary mortgage market has been a integral component of the dramatic transformation in mortgage finance which has occurred since the 1960's. The trend toward mortgage securitization began in the 1970's and has continued at a rapid pace with new and creative security instruments developed to attract additional investors to the mortgage market.

Clearly, securitization has been and will continue to be an indispensible force in U.S. mortgage markets. The growth in the secondary mortgage market has been nothing short of phenomenal. In just 6 short years, the volume of mortgage passthrough issuance has increased rapidly, rising from approximately $23 billion in 1980 to over $263 billion in 1986. For further detail, Mr. Chairman, please refer to exhibit 1 of our written statement.

Because our members rely on the provision of a stable, adequate and affordable supply of mortgage capital, and because a healthy secondary market is so vital to this goal, the National Association of Realtors is supportive of efforts to expand participation in mortgagebacked securities by permitting bank holding companies to underwrite these instruments.

However, we strongly recommend that appropriate safeguards be mandated for the conduct of this activity such as the requirement that underwriting of MBS's be carried out within a regulated structure designed to protect the financial integrity of the bank holding company and its bank subsidiary.

Banks may conduct the nontraditional activities under one of four organizational structures. (1) The bank department, an operating unit of the bank itself; (2) the bank subsidiary, a separate corporation directly owned or controlled by the bank; (3) the bank holding company subsidiary, a separate corporation owned or controlled by the company that owns the bank; and (4) the bank service corporation, a separate company owned by two or more banks.

Each of these organizational structures has different strengths and weaknesses in protecting their bank from the risks of engaging

in those nontraditional activities. However, it is important to note that no one specific structure fully guarantees that the bank will be completely insulated from risk. The bank holding company is possibly the most preferred structure for conducting expanded, nontraditional activities.

In addition to several operational advantages, this structure offers a higher degree of separation between the nonbank activities and the bank than the other structures we have mentioned.

In addition, the nonbank subsidiaries are established by the holding company, not the bank, and nontraditional activities are subject to the Federal Reserve's prior approval under section 4(c)(8) of the Bank Holding Company Act.

Any consideration of expanding BHC activity into nontraditional areas through the use of the nonbank subsidiary structure must focus upon the issue of the risks involved in that activity to the parent. There are a number of studies which have been conducted analyzing the risks that nonbank subsidiaries pose to the BHC parent. These studies indicate that while there is a correlation between the proportion of nonbank activity and BHC risk, this correlation does not necessarily mean that nonbanks are the cause of the increased risk. However, the evidence is inconclusive.

Nonbank activities appear to increase the risk for some BHC's and decrease it for others. This clearly implies that the riskiness of these activities must be considered in any decision to authorize expanded, nontraditional functions for bank holding companies and we urge this committee to keep this in mind when considering whether and under what conditions bank holding companies should be allowed to underwrite mortgage-backed securities.

Mr. Chairman, while we believe that expanding the types and the number of institutions in the mortgage securities market will benefit the housing and financial markets in general, we urge you and your committee to ensure that there will be appropriate governmental oversight of these functions. The strength and integrity of financial markets and institutions are of paramount importance to our industry and the economy and we believe that safeguards to guarantee the safety and soundness of these institutions underwriting and/or issuing these securities must be enacted by the appropriate legislative and regulatory bodies.

Thank you for the opportunity to share our views on this issue. I'll be pleased to respond to any questions.

[The complete prepared statement of Stan H. Sabin follows:]

ALAN FOX
LEGISLATIVE REPRESENTATIVE
CONSUMER FEDERATION OF AMERICA

My name is Alan Fox. I am Legislative Representative for Consumer Federation of America (CFA), which consists of over 230 local, state and national consumer, senior citizen, rural, cooperative and labor organizations that together have over 50 million members. CFA has, since 1968, represented these organizations before Congress and federal regulatory agencies on a wide variety of matters of concern to consumers.

I want to begin by making clear that CFA has no specific information on the costs or benefits to consumers of bank holding company underwriting of mutual funds. We have conducted no studies of the subject and have no formal position as to the wisdom of such a policy. My comments will be directed instead at some additional steps we believe Congress should take should it decide to permit bank holding company underwriting of mutual funds.

As this Committee has heard throughout its hearings on financial industry structure, and as CFA has testified with respect to proposed bank insurance powers, expansion of bank holding company powers present Congress with difficult balancing questions. On the one hand, increasing competition in financial services by removing barriers to entry should lead to a more efficient market and ultimately reduce consumer costs. On the other hand, the unique characteristics of banks, particularly their access to deposit insurance and the discount window, require strict controls on bank or bank holding company entry to guarantee fair competition and to ensure that the enormous public benefits received by banks do not subsidize activities unrelated to banks' basic functions. These controls must also guarantee that the deposit insurance system is not in the slightest way jeopardized by affiliates' uninsured activities.

For these reasons, bank holding company underwriting of mutual funds must be strictly regulated. The mutual fund functions must be completely walled off from the deposit and lending functions of the bank.

Furthermore, because mutual fund accounts are similar to and may be easily confused with ordinary deposit accounts, there are additional safeguards Congress should consider. At a minimum, any promotional material for a mutual fund underwritten by a bank holding company should clearly and conspicuously disclaim any connection with an affiliated bank and with federal deposit insurance. Even this restriction may not be sufficient. It may be necessary to prohibit or severely restrict cross-marketing, operations by a bank and an affiliated mutual fund at the same location, and the use of the same or a similar name by the mutual fund and its bank affiliates.

Besides these practical considerations, bank holding company underwriting of mutual funds raises a fundamental issue about the

role of banks and banking. It is the question of how banks are to serve the communities in which they operate, and how they define those communities. This issues is raised because mutual funds, unlike basic bank deposit services, are marketed to and are of benefit largely to the most affluent consumers.

Banks are unique businesses. They are chartered to serve the needs of the public -- the entire public. They are protected by a deposit insurance system mandated by the people through their representatives in Congress, a system maintained with the explicit backing of the Treasury of the United States.

The Supreme Court ruled in 1896 that national banks are "created for a public purpose" (Davis v. Elmira Savings Bank, 16 S.Ct. 502). This statement was repeated by the 3d Circuit Court of Appeals in 1939 (Smith v. Witherow, 102 F.2d 638), which went on to describe banks' business as "so intimately connected with the public interest that Congress may prohibit it altogether or prescribe the conditions under which it may be carried on." Court rulings as recently as 1980 have cited these and similar statements.

Few in the "public" will benefit from bank holding company underwriting of mutual funds. According to the Federal Reserve's 1983 Survey of Consumer Finances, 39% of all households have less than $1,000 in total financial assets. These families, many living from paycheck to paycheck, have nothing to gain from bank entry into mutual funds. Only 14% have money market deposit accounts or money market mutual funds, and only 19% own stocks. A summary of the Survey in the September 1984 Federal Reserve Bulletin found that:

> Asset holdings are much more highly concentrated than family income. More than 70 percent of the dollar holdings of nontaxable bonds, 50 percent of the stockholdings, and 39 percent of the other bonds are held by the 2 percent of families with incomes that exceed $100,000.

According to the Investment Company Institute's 1987 Mutual Fund Fact Book, the median household income of mutual fund shareholders in 1986 was $46,400, nearly twice the median income of all American families.

These are the only consumers that will benefit from bank mutual fund powers. The consumers that pay banks' steadily increasing fees and the 21% of all consumers that have dropped out or have been pushed out of the banking system will gain nothing unless Congress acts to ensure that their interests are considered.

For these consumers, many of whom live from paycheck to

STATEMENT

OF THE

NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

BY

STAN H. SABIN

CHAIR, REAL ESTATE FINANCE COMMITTEE

AUGUST 6, 1987

INTRODUCTION

Mr. Chairman, my name is Stan H. Sabin. I am a REALTOR® from Huntington Beach, California, and the 1987 Chair of the Real Estate Finance Committee of the NATIONAL ASSOCIATION OF REALTORS®. On behalf of the more than 730,000 members of our ASSOCIATION, I want to thank you for the opportunity to present our views on the subject of bank holding company underwriting of mortgage-backed securities.

THE IMPORTANCE OF THE SECONDARY MORTGAGE MARKET TO REALTORS®: FROM WALL STREET TO MAIN STREET

Mr. Chairman, we are presenting our views on this issue because any expansion in the mortgage securities market has an impact on the increasingly important secondary mortgage market. Today, no discussion of the real estate finance arena is complete without focusing on the secondary mortgage market which has become a critical link in the housing finance system.

The development of the secondary mortgage market has been an integral component of the dramatic transformation in mortgage finance which has occurred since the late 1960's. As a result of the breakdown of the previously-stable system of housing finance, innovations were developed by both the private and public sectors to better link the mortgage markets to the capital markets.

Securitization of mortgages began in the early 1970's when the government established the Government National Mortgage Association (Ginnie Mae) to securitize government guaranteed or insured mortgages. The trend toward securitization continued in the 1970's with the creation of Freddie Mac participation certificates (PCs) and Fannie Mae mortgage-backed securities (MBSs). In the early 1980's Fannie Mae and Freddie Mac also developed their popular mortgage "swap" programs, which broaden the range of funding possibilities open to thrifts and other lenders by converting mortgages into highly liquid mortgage-backed securities.

Since the development of the standard pass-through security, other instruments have been introduced which have succeeded in attracting additional and new investors to the mortgage market. Largely responding to investors' concerns about prepayment risk, collateralized mortgage obligations (CMOs), real estate mortgage investment conduits (REMICS), and stripped mortgage-backed securities ("IOs," interest only and "POs," principal only), second and third generation mortgage securities, have all been created in the 1980's, and have been successful in attracting institutional investors, foreign investors, and many new domestic investors to housing.

Clearly, securitization has been and will continue to be an indispensable force in U.S. mortgage markets. Data in Table I illustrates the concomitant growth of the mortgage securities market with annual originations of loans on one-to-four family residences. In 1980, mortgage-backed securities originations were just under 20 percent of the volume of mortgage loan originations. In 1982, at the peak of the housing depression, MBSs were 66 percent of residential loan origination volume (much of this, however, was "swap" activities). Today, mortgage-backed pass-through and collateralized securitization appears to be supporting at least one-half of the volume of residential mortgage originations. (REFERENCE: TABLE I)

Exhibit I depicts the phenomenal growth of the secondary mortgage market over the past 6 years. The volume of mortgage pass-through issuance has increased sharply since 1980, rising from approximately $23 billion in 1980 to over $263 billion in 1986. (REFERENCE: EXHIBIT I)

Because our members rely on the provision of a stable, adequate and affordable supply of mortgage capital, and because a healthy secondary mortgage market is so vital to this goal, the NATIONAL ASSOCIATION OF REALTORS® is committed to supporting initiatives which will stimulate the continued growth of the mortgage securities market.

For this reason, the NATIONAL ASSOCIATION OF REALTORS® is supportive of efforts to expand participation in mortgage-backed securities by permitting bank holding companies to underwrite these instruments, subject to the conduct of this activity within an appropriately regulated structure designed to protect the financial integrity of the bank holding company and its bank subsidiary.

COMMERCIAL BANKS AND THE BANK HOLDING COMPANY STRUCTURE

Commercial bank activity has long been heavily regulated for reasons of safety and soundness. These regulations have limited bank asset and liability portfolios, provided for examination of institution financial records, provided insurance to depositors, and provided access to the Discount Window at the Federal Reserve.

Recent deregulation of commercial bank activity has allowed these institutions to engage in such nontraditional activities as commodity trading,

personal property appraisals, commercial real estate equity financing, and/or operating a collection agency. This has raised the concern that allowing commercial banks new powers may pose some new financial risks to bank deposits, and ultimately, to the Federal Deposit Insurance Corporation (FDIC) fund.

Banks may conduct nontraditional activities under one of four organizational structures: (1) the bank department - an operating unit of the bank itself; (2) the bank subsidiary - a separate corporation directly owned or controlled by the bank; (3) the bank holding company subsidiary - a separate corporation owned or controlled by the company that owns the bank, and (4) the bank service corporation - a separate company owned by two or more banks.

Each of these organizational structures has different strengths and weaknesses in protecting a bank from the risks of engaging in these nontraditional activities. The Government Accounting Office (GAO) (April 1987), after extensive interviews with commercial bank managers, reported that commercial banks base their decisions on activities to perform and how to organize them after first determining what is optimal for the bank and the consolidated organization, and not just the affiliate bank.

For example, if the activity is relatively risk free, management may elect to perform that activity as a department, so as to begin operations as soon as possible and maximize current returns on that activity. However, if the activity is considered risky, management may elect to undertake the function only under the holding company subsidiary structure. To gain even greater legal separation from the bank, management may opt to conduct the activity under a name different from the bank or the bank holding company.

The GAO further reported that if banks cannot find a way to conduct the activity in a safe or cost-effective manner, they will reject the activity. The GAO concluded that the present set of bank operating structures provide banks and their management significant freedom to engage in these non-traditional activities and to meet their business needs.

However, it is important to note that none of the bank operating structures we have described fully guarantees that the bank will be completely insulated from risk. In fact, it is not possible to say that one specific structure insulates the bank while another does not. Moreover, decisions on which structure to use are often driven by marketing desires or operational ease in commencing new activities, rather than a full assessment of the risk inherent in their conduct.

- Bank Holding Company Subsidiaries

The bank holding company (BHC) is possibly the most preferred structure for conducting expanded nontraditional activities. The nonbank subsidiaries are established by the holding company, not the bank. Nonbank activities conducted in the bank holding company subsidiary are also subject to the Federal Reserve's prior approval under section 4(c)(8) of the Bank Holding Company Act. This process requires the holding company to notify the Federal Reserve of the BHC's intent to undertake the proposed activity. Applications to engage in nonbank activities must be decided by the Board in light of the statutory criteria specified in the Bank Holding Company Act. To determine whether a holding company may conduct any activity, the Federal Reserve evaluates the financial and managerial resources of the applicant, its subsidiaries, and any company to be acquired.

There are many advantages to the bank holding company structure as compared to the other subsidiary forms. They include:

- Bank holding companies determine in which state it may be most advantageous to establish the activity.
- Banks can take advantage of various interstate opportunities, marketing services nationwide, or favorable regulations in another state; and,
- Banks are afforded the opportunity to better compensate and retain specialized personnel by administratively separating them from the bank.

According to Federal Reserve System officials, the bank holding company subsidiary structure provides banks with (1) distinct tax advantages, (2) an avenue for conducting nonbank activities on an interstate basis, (3) greater funding flexibility through the use of commercial paper, and (4) a separate corporation operation with a separate corporation structure and separate banks and records. However, there are also several disadvantages associated with using the bank holding company structures:

- The holding company subsidiary approval process is lengthy and causes considerable uncertainty to the bank's operation;
- The administrative costs of a bank holding company operation are high relative to other structures, and it is a greater burden for smaller institutions; and
- The holding company subsidiary structure, like other subsidiary structures, does not fully protect against market perception risks.

RISE AND THE GROWTH OF NONBANK ACTIVITIES IN BHCs

With the traditional barriers between commercial banks and other financial service providers quickly disappearing, an increasing number of BHCs have requested Federal Reserve prior approval to engage in nontraditional activities. In fact, the growth in the number of nonbank subsidiaries of BHCs since 1976 has been dramatic. According to the Federal Reserve Bank of Atlanta, the number of BHCs with positive investment in nonbank subsidiaries has risen from 285 in 1970 to 447 in 1984. This growth was even greater for

The CHAIRMAN. Thank you very, very much, Mr. Sabin.

Our next witness is Kent Colton, executive vice president and chief executive officer of the National Association of Home Builders. Mr. Colton, we are happy to have you.

STATEMENT OF KENT COLTON, REPRESENTING THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. COLTON. Thank you very much, Mr. Chairman.

It's a pleasure to be here and to represent the 147,000 members of the National Association of Home Builders. Also, just for your information, before coming to NAHB, I had the chance to serve as the executive vice president of Freddie Mac, so the world of mortgage-backed securities is one that I've had a chance to deal in for a number of years.

Before I get into my formal testimony, let me just congratulate you and the members of this committee on the banking FSLIC legislation which just passed. NAHB is pleased with this legislation. We recognize the importance of this committee in both the development and the compromise process that achieved final passage on that bill.

SUPPORT FOR LEGISLATION

The purpose of my testimony today is to urge the preparation and the passage of legislation that would allow bank holding companies, as well as banks and thrifts, to underwrite and deal in private third party mortgage-backed securities.

As you know, NAHB has been a longstanding opponent to banking organizations being allowed to engage directly in real estate development and investment activities. These activities entail a high degree of risk that is incompatible with the safety and soundness of the banking system and the integrity of the Federal deposit insurance system.

However, we do not believe that these problems are to be found in allowing banking organizations and thrift institutions to underwrite and deal in mortgage-related securities.

We have reached this conclusion for three primary reasons. First, the critical and expanding role of the mortgage securities market in housing finance; second, the need for greater competition in underwriting and dealing activities; and third, because such legislation would provide opportunities to enhance the earnings and liquidity of banks and thrifts without incurring undue risks.

I would like to elaborate a bit on each of these three points.

First, mortgage-related securities which include traditional pass-throughs and various debt instruments now represent the primary means of accessing capital markets in housing finance. Table 1 in my testimony outlines the explosion of this marketplace in the last few years and table 2 shows that mortgage securities now account for more than one-fifth of all mortgage debt outstanding. More than one-half of all mortgages originated are now securitized in one form or another.

Concerning our second reason for support, the need for greater competition, I would like to stress that mortgage-backed security underwriting activities now are currently highly concentrated

among a small number of investment banking firms. In table 3 of my written testimony it points out that two firms have 58 percent of the underwriting market as of 1986, and ten firms accounted for 96 percent. Increased competition in this market is needed to reduce underwriting and trading fees as well as to improve access to capital markets for small issuers.

By contrast, the underwriting market for tax-exempt general obligation bonds where banking organizations currently participate is not concentrated. As table 4 shows, in 1986, only four participants in this market had shares over 5 percent, and the largest share was only 10 percent.

Home buyers, of course, are the ultimate beneficiaries of the MBS markets and deserve a market that is efficient and low cost, and no potential entrants are more experienced and qualified to underwrite and deal in mortgage-backed securities competitively and soundly than the Nation's banking and thrift organizations.

Regarding our third reason for support, NAHB feels that comprehensive MBS powers will help American banking and thrift institutions to compete in an emerging system of global financial markets.

As I conclude, let me point out that we believe that issues of risk and conflicts of interest should be carefully considered when expanding the powers of the Nation's banking and thrift organizations. Many of these considerations are outlined in my written testimony so I will not go into them now.

However, NAHB believes that the potential problems from underwriting and dealing in MBS are often quite modest compared to the benefits. They can be controlled through existing safeguards in the Bank Holding Company Act, the Federal Reserve Act and through proper regulation.

In this regard, I am sure you know that the Federal Reserve recently approved MBS underwriting activities for bank holding companies. In the process, they imposed volume limitations as well as prohibitions on transactions using loans originated by affiliates and the underwriting of nonrated securities.

In drafting legislation, we question whether these restrictions are necessary and our reasons are outlined in the written testimony. In general, we do not feel that the underwriting of securities backed by mortgages originated by affiliates involves conflict of interest, illegal tie-ins, or increased risk that cannot be controlled under the Bank Holding Company and the Federal Reserve Acts.

Further, because there are many situations in which high quality securities are not rated, allowing financial institutions to underwrite only rated securities would exclude them from competing in a large and growing portion of the private securities market.

Thank you for the opportunity to present our association's position and I will obviously be happy to answer questions.

[The complete prepared statement of Kent Colton follows:]

BHCs with assets in excess of $10 billion. Clearly, despite the risk of these activities, bankers apparently feel the returns are sufficient to justify the investment.

STUDIES OF THE RISK OF SUBSIDIARIES TO THE PARENT

The most direct means of analyzing the effect of nonbank subsidiaries on the stability of BHCs and their banking affiliates is to examine the activity's expected return and the variability of its return. This simple approach, however, can generate a misleading assessment of the true risk to both the BHC and the subsidiary bank. The riskiness of an activity must be viewed in a portfolio context, and not as though the activity is financially isolated. For example, an activity that appears to be relatively risky may, through diversification, substantially reduce a BHC's risk when the position of the entire organization is analyzed. There are a number of studies of the risk that nonbank subsidiaries pose to the BHC parent.

These studies indicate that while there is a correlation between the proportion of nonbank activity and BHC risk, this correlation does not necessarily mean that nonbanks are the cause of the increased risk. According, to Larry D. Wall, results seem to support the hypothesis that nonbanks either decrease BHC risk slightly or have little impact. The evidence, however, is inconclusive. Nonbank activities appear to increase the risk for some BHCs and decrease it for others. This clearly implies that the riskiness of the activities must be accounted for by the Federal Reserve. Wall (1986) concluded: "... since the observed risk reductions are sufficiently small and the evidence is sufficiently ambiguous that we cannot count on deregulation to reduce significantly the riskiness of the banking system - any deregulation of activities should be accompanied by careful monitoring of new nonbank subsidiaries."

MEASURES NEEDED TO ENSURE SAFETY AND SOUNDNESS

While we believe that expanding the types and the number of institutions in the mortgage securities markets will benefit the housing and financial markets in general, we urge the Committee to ensure that there will be appropriate governmental oversight of these functions. The strength and integrity of financial markets and institutions are of paramount importance to our industry and the economy, and we believe that safeguards to guarantee the safety and soundness of these institutions' underwriting and/or issuing these securities must be enacted.

Clearly, any structure which is selected for operation of mortgage-backed securities underwriting must provide a high degree of separation from the bank entity, and the function must be closely monitored by appropriate regulators as to protect the bank entity from the additional risks.

CONCLUSION

Thank you, once again, for the opportunity to share our views on this issue. I will be pleased to respond to any questions you may have.

TABLE I

RESIDENTIAL MORTGAGE LOANS
AND MORTGAGE SECURITIZATION

(Dollars in Billions)

Year	Residential Mortgage Loans*	MBS Origination**	Mortgage Collaterized Securities***
1977	$161.97	22.35	0
1978	$185.04	22.66	0
1979	$186.60	31.26	0
1980	$133.77	24.12	0
1981	$98.21	19.97	0
1982	$97.58	58.58	5.80
1983	$203.53	89.25	12.65
1984	$206.33	61.40	22.47
1985	$250.60	109.23	26.75
1986	$454.00	263.50	NA

*Conventional and FHA/VA 1-4 Family properties.

**Includes mortgage-backed securities issued by the Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and private sector conduits.

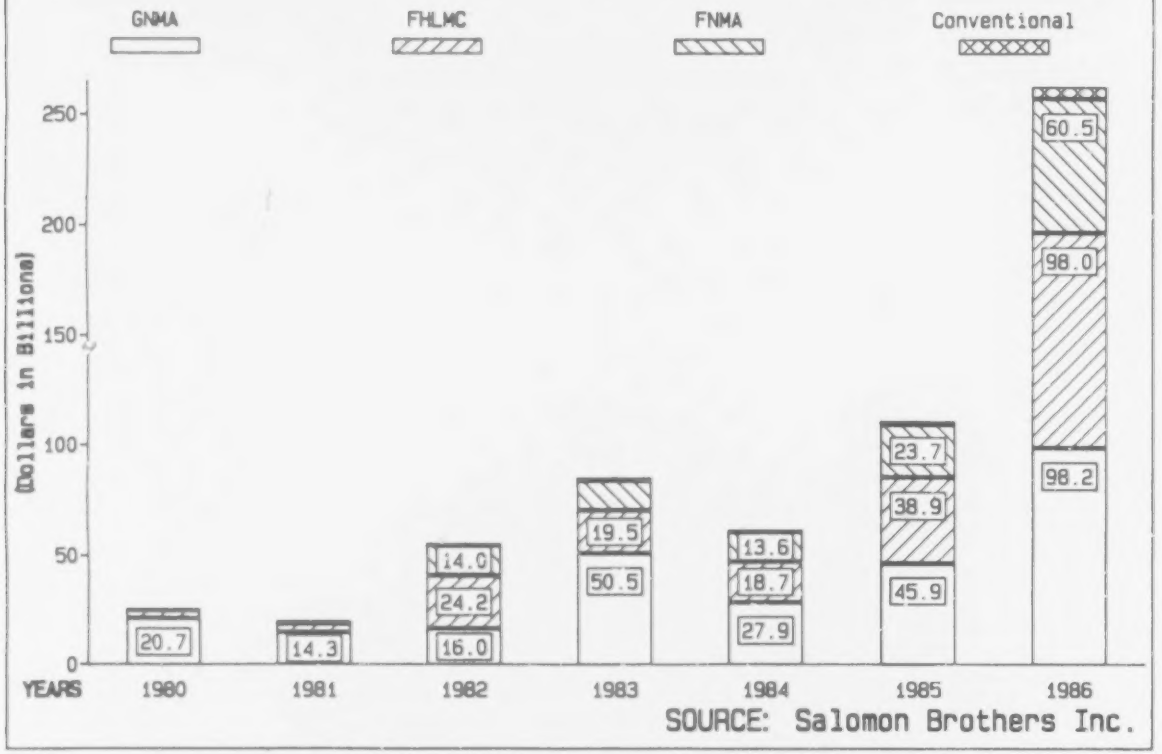
***Includes Mortgage-Backed Bonds and Collateralized Mortgage Obligations issued by Federally-related agencies, state and local agencies and private firms.

Sources: Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Government National Mortgage Association, U.S. Department of Housing and Urban Development.

(See Exhibit I for a graphical depiction of the growth in the mortgage-backed pass-through securities market.)

Exhibit 1

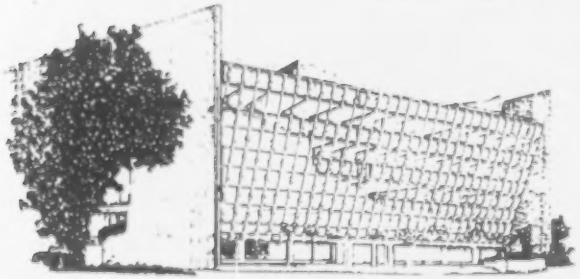
MORTGAGE PASS-THROUGH ISSUANCE: 1980 - 1986



SOURCE: Salomon Brothers Inc.

Statement of the NATIONAL ASSOCIATION OF HOME BUILDERS before the

Committee	Senate Banking, Housing and Urban Affairs
Subject	Bank Holding Company Underwriting of Mortgage-Backed Securities
Witness	Kent Colton
Date	August 6, 1987
Place	Washington, D.C.



National Housing Center
15th and M Streets, N.W.
Washington, D.C. 20005
(202) 822-0470

On behalf of the 147,000 members of the National Association of Home Builders, I am pleased to be here today to testify in support of allowing bank holding companies to underwrite and deal in private third-party issues of mortgage-related securities. Moreover, NAHB advocates underwriting of mortgage-related securities by banks and thrifts themselves. Thus, we believe that legislation should authorize expanded activity at both the holding company and institutional levels for both banks and thrifts.

NAHB supports full participation of banking and thrift institutions in mortgage-backed securities activities for 3 primary reasons: first, the critical and expanding role of the mortgage securities market in housing finance; second, the need for greater competition in underwriting and dealing activities; and, third, the much-needed opportunities to enhance the earnings, liquidity and profitability of banks and thrifts without incurring undue risk.

As this Committee well knows, NAHB has been a long-standing opponent of banking organizations being allowed to engage in real estate development and investment activities. We firmly believe that such real estate activities are unrelated to the business of banking, high-risk and fraught with potential for conflicts of interest. We also believe that bank entry into real estate development and investment would produce no public benefits, in view of the already highly unconcentrated and competitive nature of these markets.

We do not believe that any of these problems are to be found in allowing banking organizations to underwrite and deal in mortgage-related securities. Indeed, the very opposite factors hold true for underwriting mortgage securities --- the activity involves relatively low risks; and it is closely related to banks' and BHC-owned mortgage companies' activities of originating mortgages, packaging and issuing MBS, and investing in MBS. There also are substantial public benefits to be realized, especially in terms of much-needed competition, lower costs, improved service and expanded product innovation and selection. The banking industry is exceptionally experienced in analyzing and controlling both credit and market risk of mortgages and mortgage-backed securities, as well as in underwriting public agency securities -- including mortgaged-backed varieties -- both domestically and abroad.

NAHB was pleased that the Federal Reserve Board in April found the activities of underwriting and dealing in private mortgage-related securities to be closely related and a proper incident to banking, and that public benefits would clearly outweigh any possible adverse effects. We recognize, of course, that the Board made its decision within the limited language of the Glass-Steagall Act and in anticipation of protecting its decision in

the courtroom. Thus, the Board imposed a number of restrictions on the activities including volume limitations, prohibitions on transactions using loans originated by affiliates, and prohibitions on underwriting of nonrated securities.

NAHB believes that the types of restrictions the Federal Reserve Board imposed on volume, transactions and ratings should not prevail in any legislative initiative if banking organizations are to be truly competitive and the potentially enormous public benefits are to be realized. As noted above, we believe that Congress should consider broadly expanded MBS powers for both banking and thrift organizations.

ROLE OF THE SECURITIES MARKET IN HOUSING FINANCE

Mortgage-related securities -- which include traditional pass-throughs and various debt instruments -- now account for the majority of mortgages sold in the secondary markets and represent the primary means of accessing capital markets for housing finance. New types of mortgage-backed securities recently have been developed, including private pass-through securities, pay-through and zero-coupon bonds, home buyer bonds and collateralized mortgage obligations (CMOs). Expansion of the market was facilitated by the Secondary Mortgage Market Enhancement Act of 1984, and passage of the 1986 Real Estate Mortgage Investment Conduit (REMIC) legislation has cleared the way for a stronger MBS market of greatly expanded potential. The volume of mortgage securities issued in 1986 amounted to $159.0 billion (Table 1). Mortgage securities are now as important in annual fundings as corporate bonds and, in fact, raised more funds in the credit markets in 1986. Mortgage securities now account for 22% of all mortgage debt outstanding, up from 7% in 1977 (Table 2). Over half of all mortgages originated are now securitized in one way or another.

These trends are not likely to change. Further market expansion is being stimulated by innovations in market instruments, private-sector conduit issuers, and the attraction of European and Asian investors to mortgage-backed securities. In the Association's opinion these new instruments represent a significant move into the mortgage markets by private institutions, a development that can only benefit borrowers by increasing the availability of affordable mortgage credit.

Underwriting and dealing in private mortgage-related securities are activities closely related to banking. BHCs, banks and mortgage banking affiliates already issue, underwrite and deal in GNMA, FNMA, and FHLMC mortgage securities, as well as other eligible securities. They may issue and, in many cases, also underwrite and deal in their own private pass-through issues and their own private CMO issues. U.S. banks may also underwrite private securities abroad and are leaders in the Eurobond markets. What they cannot do under current law is curiously incongruous with what they can do. For example, a bank may purchase agency securities issued by a third party, but it may not underwrite that third-party's CMO or REMIC backed by the very same agency securities. A bank may purchase whole

mortgage loans from an originator, then issue and underwrite its own security backed by those mortgages, but if the originator itself issued the identical private security backed by those same mortgages, then the bank could not underwrite it.

Any time a bank purchases mortgages or a private MBS for portfolio, assumes the credit and market risk for a period of time, and subsequently sells the loans, it also sustains the fundamental risk of underwriting an MBS -- that is, the credit risk of the underlying mortgages. Subsequent securitization involves only marginal market risk by the underwriter, who hedges the security and sells the asset at no or very slight risk.

PUBLIC BENEFITS

NAHB firmly believes that the entry of banking institutions into private mortgage securities underwriting would produce public benefits that far outweigh possible adverse effects. These public benefits include increased competition and increased efficiency, the creation of value in the market, and the development of a strong private secondary market for mortgage securities.

1. Increased Competition

Virtually all mortgage-backed securities are underwritten by a handful of investment banking firms. The rapid and remarkable growth of private securities during the past three years has only concentrated this activity further.

The underwriting market for mortgage-related securities is exceptionally concentrated. In 1986, 2 firms had 58% of the market share for mortgage and asset-backed debt issues (the latter a negligible proportion). Although this share had declined from 68% in 1985, the same top ten firms increased their share from 94% to 96% of the market from 1985 to 1986 (Table 3). These market shares held fairly steady while the volume of the total market skyrocketed from $21 billion in 1985 to $67 billion in 1986.

By contrast, the underwriting market for tax-exempt general obligation bonds, a part of the larger municipal market and one in which banking organizations currently participate, is highly unconcentrated. In 1986, only 4 participants in the general obligation market had shares over 5% and the largest share was only 10% (Table 4).

In addition, banking organizations have long been active in private placements of privately issued third-party securities. This private placement market, dominant as recently as 1985, has been declining, however, as private securities are increasingly being publicly distributed. Although no market data exists, the industry estimates that private issues are now publicly distributed three times more often than they are privately placed. Thus, if BHCs are not authorized to underwrite MBS, the market for private issues will continue to consolidate within the investment banking firms.

NAHB believes that increased competition in this market is needed very much. We believe it would reduce underwriting and trading fees; improve access to capital markets for small mortgage lenders and builders; enable banking institutions to provide more services for their builder customers; attract new investors, enhance development of innovative mortgage security products; and strengthen credit enhancement and pool protection services.

NAHB wishes to note also that the competitive issue is also integral to the ability of the American banking system to hold its own in an emerging system of global financial positions. NAHB believes that the American banking industry's ability to funnel foreign capital to meet domestic credit needs is important not only for mortgages but for other investment needs. We also believe that the ability of U.S. banks to compete equitably with foreign banking concerns is a key to dealing with future issues related to international trade and economic development, as well as to international and domestic financial stability.

2. Creation of Market Value for Bank Earnings

NAHB also believes that increased competition will contribute to greater product quality and product value, which are consistent with the safety and soundness of the banking industry. The ability of BHCs to underwrite and deal in MBSs will create value for both lenders and investors by generating liquidity as well as direct and indirect opportunities for BHCs to increase earnings and to provide services. For example, additional commissions can be made in the aftermarket in which the securities are subsequently resold, while fees can be earned by providing related services such as hedging programs for issuers. Most importantly, however, the banking organization can attract and develop new customer relationships that, while benefiting the BHC's earnings through cross-selling opportunities, will result in better service to customers. In this respect, NAHB is particularly interested in opportunities for BHCs to structure retail MBS small savers' investments.

3. Expansion of Private Secondary Market

The Association has been concerned by ongoing initiatives of the current Administration that focus on reducing the role of the public secondary market agencies (GNMA, FNMA and FHLMC) in the capital markets. These initiatives and proposals include user fees on agency issues, privatization of FNMA and FHLMC, lowering the agencies' loan purchase limits, and limiting FHLMC's activity level. The Administration's efforts are clearly aimed at making the public agencies less competitive, and these initiatives underscore the need for more and stronger entrants into the private mortgage securities market.

In addition, we note that securities backed by nonconforming loans have become increasingly important for the supply of mortgage money to high-cost areas where the average home price exceeds limits for FHA/VA, FNMA and FHLMC loan amounts. Citicorp's conduit for these so-called "jumbo"

loans currently provides an invaluable source of funds for these areas, and we believe that the ability of BHCs to underwrite and deal in third-party issues would expand and strengthen this growing market.

We do not believe that BHCs should be limited to single-family residential mortgage-related securities, but should be encouraged to develop high quality securitization products for the financing of multifamily properties. In addition, BHCs should have some future flexibility with regard to securities backed by nonresidential properties, particularly in light of the new REMIC legislation.

SAFEGUARDS ON RISK & CONFLICTS OF INTEREST

As with any product or service offered by banking institutions, NAHB is concerned about potential risks as well as abuses involving conflicts of interest and illegal tie-ins. NAHB does not believe that underwriting and dealing in mortgage-related securities entails undue risk or potentials of conflicts of interest to the banking organization. Banks already have the experience to make sound decisions regarding the investment quality of securities and their underlying mortgages. Moreover, we believe that the combination of existing safeguards in the Bank Holding Company Act and Sections 23A and 23B of the Federal Reserve Act are adequate to guard against potential abuses.

1. Credit and Market Risk of Underwriting

NAHB believes that the primary safeguard for BHCs underwriting MBS is the relatively low risk of this activity. As reflected in the examples described earlier, there is no functional difference between underwriting third-party securities and self-underwriting an issue backed by a third-party's loans or securities, as is currently permitted. Nor is there a significant difference in risk.

The credit risk of underwriting an MBS differs fundamentally from underwriting other types of equity and debt securities such as stocks and corporate bonds. In the latter case, the issuer's payments on the obligations are derived from its earnings; thus, credit quality in terms of the issuer's earnings, liquidity and profitability is paramount in assessing risk. In an MBS or other asset-backed security, however, the issuer's payments of principal and interest to the investor derive from the cash flow of principal and interest payments on the underlying mortgages. The issuer's credit quality is secondary to the credit quality of the collateral, and in many cases is not even considered a factor in rating an MBS. Thus, the assessment and control of risk in underwriting MBS is the same as that in purchasing mortgages and MBS, which banking organizations routinely do.

For much the same reasons, the market risk of underwriting MBS is not substantially different from that entailed in holding mortgages and MBS in portfolio; in managing a mortgage pipeline in preparation for pooling a security; or in underwriting a bank's own security issue. These activities

have been determined by Congress and the regulators as carrying a level of risk that is acceptable and consistent with maintaining safety and soundness.

A great deal of publicity has surrounded huge losses in MBS transactions last year and this year by the largest securities firms: Merrill Lynch, First Boston, Salomon Brothers and Goldman Sachs. These losses, however, resulted not so much from underwriting as from poorly controlled or executed trading positions in the market, primarily for the firms' own accounts. These positions reflected a conscious speculative move on the part of certain traders in violation of individual position limits and other internal controls imposed by their respective investment banking houses.

Considerable publicity also surrounded the MBS losses of Bank of America and the collapse of EPIC Mortgage in 1985. These were isolated incidents in which fraud and misrepresentation played a leading part. Indeed, it is a credit to the banking industry's conservative practices that few, if any, banking organizations invested in the EPIC securities.

3. Conflicts of Interest

As stated earlier, NAHB believes that protections against potential conflicts of interest and illegal tie-ins are adequately provided in the Bank Holding Company Act and in Sections 23A and 23B of the Federal Reserve Act. These provide for "arm's-length" transactions between affiliates that must be consistent with standards for transactions with nonaffiliated parties. To this end, NAHB approves of such regulatory controls as limits on buying and lending by affiliates during the underwriting period; the requirement for separate and adequate capitalization that will not be included in the BHC's consolidated minimum capital requirement; and extensive disclosures to customers about affiliate transactions.

NAHB would like to point out two conditions imposed by the Federal Reserve Board, specifically on mortgage-backed securities underwriting activities, that we do not believe should be contained in legislation. The first is the prohibition on underwriting mortgage securities issued by an affiliate or backed by mortgages originated by an affiliate, be it a bank or mortgage banking company. The second condition permits BHCs to underwrite only mortgage-backed securities that are rated in one of the top four categories by a national ratings service. We believe that these conditions are not necessary in order to prevent conflicts of interest and risk where regulatory disclosures and industry standards can provide adequate safeguards. Furthermore, such limitations are likely to impede the achievement of the public benefits to be derived from this activity in terms of efficiencies, lower costs and increased competition.

a. Affiliate Securities and Mortgage Originations

NAHB does not believe that the underwriting of securities backed by mortgages originated by holding company affiliates involves conflicts of interest or increased risks. An arm's length analysis of the credit quality

of the underlying mortgages, on the same terms as an analysis of a third-party's originations, should not be prohibited. The vast majority of mortgages, including jumbo and nonconforming loans, are underwritten in accord with industry-wide agency or mortgage insurance standards. Thus, it strikes us as ironic that, under the Federal Reserve's order, a bank or mortgage company affiliate can purchase third-party mortgages underwritten using its own accepted standards, and issue a security to be underwritten by the securities affiliate, but it cannot do so with its own comparable mortgages.

There is no such restriction on securities firms underwriting MBSs backed by loans originated by their mortgage banking, "nonbank" bank, and thrift subsidiaries or affiliates. In at least two cases, investment companies can underwrite securities backed by mortgages that are not only originated by affiliates but that are insured by another affiliate. This mortgage insurance affiliate can even provide the pool insurance for the security itself. To our knowledge, securities affiliates of thrifts are prohibited only from underwriting and dealing in the thrift's equity securities.

These transactions require only adequate SEC disclosures of relationships among the affiliates. NAHB strongly believes that disclosures required by SEC and the Federal Reserve would protect customers and investors in transactions involving BHC affiliates. The extensive legal liability of an underwriter that misrepresents the quality of the collateral is a more-than-adequate deterrent to "dumping" an affiliate's low-quality loans onto securities investors. At the same time, rules similar to the Fed's and the OCC's "60-day" rules would prevent affiliates from bailing out the underwriting affiliate and its syndicate partners from a bad issue.

b. Authority to Underwrite Nonrated Securities

As desirable as ratings on securities are, there are nevertheless many situations in which high quality securities are not, in fact, rated. Allowing BHCs to underwrite only rated securities excludes them from competing in a large and growing portion of the private mortgage-backed securities market. Currently, a significant number of securities backed by jumbo and other nonconforming mortgages are not rated, and securities backed by ARMs are increasingly not being rated. Many issuers deliberately structure such securities to avoid the need for and cost of obtaining a rating. One of the most popular and safe of these is the senior/subordinated structure often used in CMOs and REMICs. We do not believe BHCs should be precluded from participating in this portion of the market. In our opinion, BHCs should also be able to underwrite MBS that are eligible to be rated --- that is, they meet the ratings requirements and could be rated --- in addition to those that are rated. Another possibility would be to use the Comptroller of the Currency's criteria of "investment grade" securities; that is, eligible for purchase or holding by a national bank on the basis of quality and marketability.

CONCLUSION

In NAHB's view, the primary issue regarding the authority of bank holding companies to underwrite and deal in mortgage-realted securities is the stunning growth of the mortgage securities market. MBSs serve investor needs, but more importantly they serve individual borrowers' needs by ensuring a dependable and affordable supply of funds. Homebuyers are the ultimate beneficiaries of the MBS markets and deserve a market that is competitive, efficient, and low-cost.

Underwriting and dealing in mortgage-related pass-through and debt securities also offer needed opportunities for banking and thrift organizations to diversify their earnings, enhance their profitability and improve their liquidity without incurring undue risk.

The market for underwriting MBS is notably lacking in competition and seriously needs new entrants. In the Association's view, no potential entrants are more experienced and qualified to underwrite private MBSs competitively and soundly than the Nation's banking and thrift organizations.

I thank you for the opportunity to express the Association's position. I will be happy to answer any questions that the Committee may have.

Table 1. Funds Raised in U.S. Credit Markets ($ in billions)

Type of Security	Calendar Year									
	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
U.S. Treasury Securities	$57.6	$55.1	$38.8	$79.8	$87.8	$162.1	$186.7	$199.0	$223.7	$214.7
Corporate [a/] Bonds	31.1	28.6	25.1	28.5	27.2	31.2	28.1	69.4	110.5	131.5
Mortgage Pools	20.5	13.6	23.1	19.2	15.0	49.5	66.4	44.4	79.9	159.0
Totals for 3 Security Types	109.2	97.3	87.0	127.5	130.0	242.8	281.2	312.8	414.1	505.2
Mortgage Pools as percent of:										
U.S. Treasury Securities	35.6%	24.7%	59.5%	24.1%	17.1%	30.5%	35.6%	22.3%	35.7%	74.1%
Corporate Bonds	65.9	47.6	92.0	67.4	55.1	158.7	236.3	64.0	72.3	120.9
Totals for 3 Security Types	18.8	14.0	26.6	15.1	11.5	20.4	23.6	14.2	19.3	31.5

[a/] Private domestic financial and non-financial corporations

Sources: Federal Reserve Bulletins (various issues)

Table 2. Outstanding Debt ($ in billions)

Type of Security	End of Calendar Year 1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	Mar. 31 1987
U.S. Treasury (Marketable debt)	$459.9	$487.5	$530.7	$623.2	$720.3	$881.5	$1050.9	$1247.4	$1437.7	$1619.0	$1635.7
Corporate [a] Bonds	317.4	346.2	373.5	411.0	446.2	480.0	505.5	571.1	664.2	NA	NA
Mortgage Pools	70.3	88.6	119.3	142.3	163.0	216.7	285.1	332.1	415.0	529.8	575.6
Totals for 3 Security Types	847.6	922.3	1023.5	1176.5	1329.5	1578.2	1841.5	2150.6	2516.9	NA	NA
All Mortgage Debt	(1023.4)	(1169.4)	(1326.8)	(1471.8)	(1583.3)	(1658.4)	(1827.6)	(2033.7)	(2266.9)	(2563.8)	(2622.4)
Mortgage Pools as percent of:											
U.S. Treasury (Marketable Debt)	15.3%	18.2%	22.5%	22.8%	22.6%	24.6%	27.1%	26.6%	28.9%	32.7%	35.2%
Corporate Bonds	22.1	25.6	31.9	34.6	36.5	45.1	56.4	58.2	62.5	NA	NA
Totals for 3 Security Types	8.3	9.6	11.7	12.1	12.3	13.7	15.5	15.4	16.5	NA	NA
All Mortgage Debt	6.9	7.6	9.0	9.7	10.3	13.1	15.6	16.3	18.3	20.7	21.9

[a] Private domestic non-financial corporations

Sources: Federal Reserve Bulletins (various issues)
Annual Statistical Digests of the Board of Governors, Federal Reserve System (various issues)
Treasury Bulletin, June 1987

Table 3. Underwriting Market Shares for Mortgage and Asset-Backed Debt, 1985 and 1986

	1986 Amount ($ Millions)	1986 % of Total	1985 Amount (Millions)	1985 % of Total	Increase in Volume 1985-86 (Millions)		% Share of Total Industry Increase
Industry Totals	$66,916.5	100.0	$20,958.7	100.0	$45,957.8	219.3%	100.0
First Boston	20,961.2	31.3	6,917.0	33.0	14,044.2	203.4	30.6
Salomon Brothers	17,787.1	26.6	7,412.5	35.4	10,374.6	140.0	22.6
Merrill Lynch Cap. Mkts.	7,592.3	11.3	1,194.2	5.7	6,398.1	535.8	13.9
Shearson Lehman Brothers	4,096.7	6.1	1,560.5	7.4	2,536.2	162.5	5.5
Morgan Stanley	3,804.5	5.7	322.7	1.5	3,481.8	1,079.0	7.6
Kidder, Peabody	3,095.4	4.6	369.7	1.8	2,725.7	737.3	5.9
Goldman, Sachs	2,590.4	3.9	298.5	1.4	2,291.9	767.8	5.0
Drexel Burnham Lambert	1,557.3	2.3	979.5	4.7	557.8	59.0	1.2
Prudential-Bache Securities	1,395.1	2.1	91.2	0.4	1,303.9	1,429.7	2.8
Painewebber	1,211.2	1.8	544.5	2.6	666.7	122.4	1.5
Top 2	38,748.3	57.9	14,329.5	68.4	24,418.8	170.4	53.1
Top 5	54,241.8	81.1	17,406.9	83.1	36,834.9	211.6	80.1
Top 10	64,091.2	95.8	19,690.3	93.9	44,400.9	225.5	96.6

Source: Investment Dealers Digest, January 12, 1987.

Table 4. 1986 Market Shares of Top 10 Underwriters in Each Category (Full Credit to Lead Manager)

Underwriter Rank	Mortgage-Backed Debt	Bank-Eligible State and Local General Obligations*
1	31.3%	10.9%
2	26.6	9.4
3	11.3	7.2
4	6.1	6.1
5	5.7	4.7
6	4.6	4.5
7	3.9	4.1
8	2.3	4.0
9	2.1	3.0
10	1.8	2.6
Top 2	57.9	20.3
Top 5	81.1	38.3
Top 10	95.8	56.5

* Banking organizations compete in underwriting tax-exempt General Obligations which are part of the total municipal market. Four are in the top 10 in the general obligation market. The highest ranking bank in the total municipal market was 12th.

Source: Investment Dealers Digest, January 12, 1987

The CHAIRMAN. Thank you very much, Mr. Colton.

Has Mr. Guthman come in the room? Apparently not.

Mr. Geltman, I understand you are the general counsel of the National Governors' Association. We are delighted to have you here. Go right ahead.

STATEMENT OF RICHARD B. GELTMAN, STAFF DIRECTOR, COMMITTEE ON ECONOMIC DEVELOPMENT AND TECHNOLOGICAL INNOVATION, AND GENERAL COUNSEL, NATIONAL GOVERNORS' ASSOCIATION

Mr. GELTMAN. Thank you. It's particularly a pleasure for me to testify before Senator Bond—I want to say Governor Bond—since I worked with him very closely for a period of years. I think he may even have testified at one time or another in behalf of States' being able to have their municipal revenue bonds underwritten by commercial banks. So this area will not be unfamiliar to him.

The National Governors' Association has longstanding policy supporting action by Congress to authorize expressly banks and bank holding companies to underwrite and deal in revenue bonds issued by State and local governments.

Municipal revenue bonds are important to State and local governments because they provide financing for public power, toll roads, toll bridges, water and sewer facilities, and similar infrastructure improvements supported by user charges or dedicated revenue sources rather than from the general taxing authority.

It is our judgment that permitting banks and bank holding companies to participate in the marketing of municipal revenue bonds will increase competition for securities underwriters, brokers, and dealers. That competition will drive down costs of issuance and increase the market for these bonds. The resulting savings we estimate to be significant. A review by Professor William Silber of New York University of 12 studies by 9 different research teams concluded that increased competition by banks and bank holding companies would result in savings to State and local governments of between 6.7 and 13.3 basis points. This conclusion is consistent with GFOA's estimate [Government Finance Officers Association] of a 5 to 10 basis points differential.

Increased competition in the market, now served exclusively by securities firms, will reduce the fees imposed by underwriters for bringing new issues to market.

The additional competition provided by banks should result in reductions in both competitive and negotiated bids. First, the addition of banks as underwriters should make it more feasible to sell municipal revenue bonds at competitive bid, a method which is generally less costly. Second, the addition of banks as potential underwriters increases demand by increasing potential underwriting syndication partners. Third, because banks have existing and different customer bases than securities firms, banks will bring to the municipal revenue bond market investors who have shied away from revenue bonds in the past. Fourth, the participation by banks will increase investor trust in municipal revenue bond instruments, encouraging additional bond purchases at the retail level.

A second major reason for anticipated savings by State and local governments is that the participation of banks as dealers in the secondary market will mean that municipal revenue bonds will be more liquid. Liquid securities are more attractive and therefore will sell initially at a lower rate of interest than securities that are less liquid. An expanded dealer market is crucial because municipal revenue bonds are not sold in the major exchanges. They are sold through the network of broker/dealers. An expanded network will mean a more public and open marketplace. As in the case of new issues, an expanded secondary market sales force is likely to result in additional buyers for revenue bonds.

Congress should permit banks to underwrite municipal revenue bonds in order to reduce the unnecessarily high concentration ratios in the municipal revenue bond underwriting market. Because there are so many local and regional banks that may opt to underwrite local government issues, it is likely that there would be local alternatives to national or regional money center institutions. Furthermore, local syndications with regional broker/dealers become a possibility. The presence of additional financial intermediaries in widely dispersed locations will give nonfinancial center States and small local communities the same access to capital markets now enjoyed by these States and localities whose general obligation bonds may be underwritten by local banks.

Permitting banks to underwrite and deal in municipal revenue bonds is a diversification strategy that is likely to improve the safety and soundness of banking institutions. It appears that municipal bonds have a default rate of less than 0.2 of 1 percent. Many revenue bonds currently not eligible for bank underwriting carry higher ratings than eligible revenue bonds or general obligation issues. There is no evidence that revenue bonds have a significantly higher risk of default. In fact, due to a quirk—and we would say an error—in the bankruptcy code, it seems that holders of revenue bonds and general obligation bonds issued by the same failing municipality are equally exposed to other creditors' claims.

Banks may and do currently hold municipal revenue bonds in their investment portfolios. However, underwriting and dealing in these securities are no riskier than holding those securities or underwriting and dealing in general obligation bonds. The principal risk of underwriting any issue of securities is market risk—that is, the risk of declining prices during the underwriting period or in the secondary market, while the underwriter is holding the security in its dealer inventory. This risk is virtually the same risk as holding these same securities.

In summary, the National Governors' Association recommends that banks and bank holding companies be permitted to underwrite and deal in municipal revenue bonds. The increased bank competition should result in decreased revenue bond interest rates, providing savings to State and local governments. At the same time, the safety and soundness of commercial banks would be enhanced.

Mr. Chairman, I would be glad to answer any questions.

[The complete prepared statement of Richard B. Geltman follows:]

The CHAIRMAN. Thank you, Mr. Geltman.

Senator GARN. I would also just make one other brief comment. Mr. Guthman is not here to make his statement in behalf of the National League of Cities, although I read through it, and as a former president of the National League of Cities who testified as a mayor, the testimony is the same as I gave 15 years ago. So I can certify his testimony if he doesn't come. The National League of Cities, all the cities, the Governors, former mayors really believe that cities, counties and States will get a better deal if there's more competition for municipal revenue bonds.

So the story hasn't changed in 15 years, Mr. Chairman.

The Chairman. Senator Garn, your speech is like wine. It just gets better with time. [Laughter.]

I hear it again and again, but every time I hear it I like it more. Now if you would like to go down and take Mr. Guthman's place and testify for us, we'd be delighted to have you do it.

Mr. GELTMAN. It sounds as if he could testify for the National Governors' Association as well.

The CHAIRMAN. Thank you very much.

Mr. Kaufman, you are one of the most respected financial economists in the Nation and your testimony this morning, as usual, is as thorough a review of the issues as we could hope for. In your analysis, however, I did not find an answer to this key question: Would bank entry into mortgage-backed securities, commercial paper and municipal bond underwriting, and especially mutual fund sponsorship, result in concrete customer benefits in the form of lower costs associated with those activities?

Mr. KAUFMAN. I think it will in some areas, not in all. In the well-established areas, such as municipal revenue bonds, probably not a great deal and not as much as I think the previous witness said.

In the newer areas of mortgage-related securities, where competition has not had a chance to build up, where it takes very large amounts of capital and especially human capital—these are very complex instruments—to move in, in these areas I see the entry of banks having an immediate effect.

Contrary to Senator D'Amato's opening statement, I think that many people overlook that the benefits of bank entry into these areas will occur not only in the big markets, not only for the big banks who are the banks who have been actively seeking these powers, but I think in the smaller areas. In these smaller towns, in the smaller communities in this country is where the investment bankers are the weakest, and where they are, they often have branch offices. Yet banks do have their local offices there. I think we will see an intensification of competition in the securities market in smaller towns and small areas of this country as the small banks see that they have an opening and where they will not be faced with the Goldman, Sachs, the Salomon Brothers, the Morgan Stanleys that the Bankers Trust, Citicorp, and Morgan Guarantys are faced with.

The CHAIRMAN. That's a fascinating response. As you know, Missouri and Wisconsin and the other States have many small towns where you have a banker who knows the town thoroughly. It seems to me he would be the logical person to help underwrite revenue

bonds for a program based primarily in that community. Current law prevents him from doing so, and it's pretty hard for me to understand why we shouldn't correct that.

Mr. Fox, your comments on the limited value of mutual fund authority to moderate income households is an important perspective for this committee to keep in mind. I was troubled by that, however. After all, you said that the average income was something like $46,000 for people who have mutual funds.

Well, that's still millions of households and that's tens of millions of people who are consumers, too. I know you represent them. After all, even if the benefits would be confined to a third or a fourth of the market of high income people, why shouldn't they get the benefit of competition?

Mr. Fox. There's no reason why they shouldn't. I think it could be argued that they already have such a great number of choices that perhaps it would be more productive for Congress to focus its attention on those consumers who don't have the multiplicity of choices and to try to expand those choices, rather than to put time into the consumers who have already a wide variety of choices.

My point is not that it's a bad thing to do to provide additional options for upper income Americans, but that Congress ought to use this opportunity to ensure that all consumers or the vast majority of consumers have an opportunity to directly benefit from these hearings and from these considerations.

The CHAIRMAN. Well, then, are you saying that banks should not be permitted to offer mutual funds unless they are also required to offer the two basic banking services that you describe?

Mr. Fox. That's correct. I think that's the only way that there can be that sort of guarantee that all consumers will have the opportunity to benefit from bank offering of mutual funds.

The CHAIRMAN. They might not do either one.

Mr. Fox. I'm sorry?

The CHAIRMAN. They might decide not to do either one.

Mr. Fox. Well, in that case, I think those consumers who are interested in mutual funds haven't lost very much. They may stand to gain a little bit from having additional access to additional mutual funds, but they really haven't lost very much in terms of options. They already have a wide variety of options for their savings and for their funds.

The CHAIRMAN. Mr. Sabin, in your statement you provided a thorough review of the soundness implications of expanding bank holding company powers to include mortgage-backed securities underwriting, and this Senator will keep your recommendations in mind as he considers the matter further.

Of crucial interest, however, is whether bank holding company entry into this activity will improve the competetive situation in the mortgage-backed securities underwriting area and will result in concrete reductions in the cost of mortgage credit and improvements in mortgage credit availability.

So is it your testimony, that of your association, that these benefits will be realized if bank holding companies are permitted to engage in mortgage-backed securities underwriting?

Mr. SABIN. Mr. Chairman, we don't have any specific statistics on this belief, but we do have a belief and one that is shared by

National Governors' Association

John H. Sununu
Governor of New Hampshire
Chairman

Raymond C. Scheppach
Executive Director

Testimony of

RICHARD B. GELTMAN
Staff Director
Committee on Economic Development and
Technological Innovation
NATIONAL GOVERNORS' ASSOCIATION

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

regarding

Bank Underwriting of
Municipal Revenue Bonds

August 5, 1987

Mr. Chairman:

Thank you for inviting a representative of the National Governors' Association to testify before you today on permitting bank holding companies, national banks and federally insured state-chartered banks to underwrite and deal in municipal revenue bonds.

The National Governors' Association has long-standing policy supporting action by Congress to authorize expressly banks and bank holding companies to underwrite and deal in revenue bonds issued by state and local governments. Our policy position A.-8, State and Local Bonds, reads in relevant part: "In addition, we support current efforts to increase competition for underwriting revenue bonds in view of the potential of this initiative to reduce significantly the cost of revenue bond financing." Our position is similar to that of other major public interest groups representing state and local elected officials: the National Conference of State Legislatures, the National League of Cities, the National Association of Counties, and the United States Conference of Mayors. The Government Finance Officers Association (GFOA) have asked us expressly to indicate that they join us in support for such statutory authorization for banks and bank holding companies.

Municipal revenue bonds are important to state and local governments because they provide financing for public power, toll roads, toll bridges, water and sewer facilities, and similar infrastructure improvements supported by user charges or dedicated revenue sources rather than from the general taxing authority.

It is our judgment that permitting banks and bank holding companies (and their subsidiaries) to participate in the marketing of municipal revenue bonds will increase competition for securities underwriters, brokers and dealers. That competition will drive down costs of issuance and increase the market for these bonds. The resulting savings we estimate to be significant. A review by Professor William Silber of New York University of 12 studies by nine different research teams, concluded that increased competition by banks and bank holding companies would result in savings to state and local governments of between 6.7 and 13.3 basis points (1 basis point equals 1/100 of an interest rate percentage point). This conclusion is consistent with GFOA's estimate of 5 to 10 basis points differential. While long-term bonds typically contain terms of 20 or 30 years, the average bond term after calls is approximately 12 years. Annual savings for each set of bonds can then be aggregated over the 12 years' life the bonds can be expected to be outstanding. The total dollar savings of over the life of the bonds, therefore, is considerable.

Increased competition in the market, now served exclusively by securities firms, will reduce the fees imposed by underwriters (underwriters' spread) for bringing new issues to market. The underwriters' spread is the difference between the price the underwriters pay the issuers for the securities and the price at which the securities are resold in the market.

The additional competition provided by banks should result in reductions in both competitive and negotiated bids. First, the addition of banks as

underwriters should make it more feasible to sell municipal revenue bonds at competitive bid, a method which is generally less costly. Second, the addition of banks as potential underwriters increases demand by increasing potential underwriting syndication partners. Third, because banks have existing and different customer bases than securities firms, banks will bring to the municipal revenue bond market investors who have shied away from revenue bonds in the past. Fourth, the participation by banks will increase investor trust in municipal revenue bond instruments, encouraging additional bond purchases at the retail level. In recent months, underwriting fees for revenue bonds where commercial banks are not allowed to compete, have been $1, $2, or even as high as $5 per $1,000 of par value over the fees for comparable issues of general obligation bonds where banks do compete.

A second major reason for anticipated savings by state and local governments is that the participation of banks as dealers in the secondary market will mean that municipal revenue bonds will be more liquid. Liquid securities are more attractive and therefore will sell initially at a lower rate of interest than securities that are less liquid. An expanded dealer market is crucial because municipal revenue bonds are not sold in the major exchanges. They are sold through the network of broker/dealers. An expanded network will mean a more public and open marketplace. As in the case of new issues, an expanded secondary market sales force is likely to result in additional buyers for revenue bonds.

A third major reason for permitting banks to underwrite and deal in municipal revenue bonds is to provide an incentive for banks to continue to purchase municipal bonds. Until the last several years, commercial banks have been the greatest holders of municipal bonds. However, as Congress over time eliminated the income tax deduction banks could take for interest rate expenses incurred in acquiring or holding municipal bonds, banks have not increased their municipal bond holdings. Banks may be more inclined to hold municipal bonds if they feel they can maintain a customer relationship that might also lead to underwriting of municipal revenue bond issues.

Congress should permit banks to underwrite municipal revenue bonds in order to reduce the unnecessarily high concentration ratios in the municipal revenue bond underwriting market. In that part of the municipal revenue bond market from which banks are excluded, the top ten underwriters control 57 percent of the market, while in the municipal general obligation bond market where banks can compete, the top ten underwriters account for only 31 percent of the market. Because there are so many local and regional banks that may opt to underwrite local government issues, it is likely that there would be local alternatives to national or regional money center institutions. Furthermore, local syndications with regional broker/dealers become a possibility. The presence of additional financial intermediaries in widely dispersed locations will give non-financial center states and small local communities the same access to capital markets now enjoyed by these states and localities whose general obligation bonds may be underwritten by local banks.

Permitting banks to underwrite and deal in municipal revenue bonds is a diversification strategy that is likely to improve the safety and soundness of banking institutions. It appears that municipal bonds have a default rate of

less than .2 of 1 percent. Many revenue bonds currently not eligible for bank underwriting carry higher ratings than eligible revenue or general obligation issues. There is no evidence that revenue bonds have a significantly higher risk of default. In fact, due to a quirk -- we would say an error -- in the bankruptcy code, it seems that holders of revenue bonds and general obligation bonds issued by the same failing municipality are equally exposed to other creditors' claims.

Banks may and do currently hold municipal revenue bonds in their investment portfolios. However, underwriting and dealing in these securities are no riskier than holding these securities or underwriting and dealing in general obligation bonds. The principal risk of underwriting any issue of securities is market risk -- that is, the risk of declining prices during the underwriting period or in the secondary market, while the underwriter is holding the security in its dealer inventory. This risk is virtually the same risk as holding these same securities. And, as the staff of the Federal Reserve Board has found, there is no reason that underwriting and trading in presently ineligible revenue bonds is more risky than underwriting and trading in presently eligible revenue bonds or general obligation bonds.

In summary, the National Governors' Association recommends that banks and bank holding companies be permitted to underwrite and deal in municipal revenue bonds. The increased bank competition should result in decreased revenue bond interest rates, providing savings to state and local governments. At the same time, the safety and soundness of commercial banks would be enhanced.

Mr. Chairman, I'd be glad to answer any questions.

many in the industry, including our colleagues the home builders, that the increased competition which would be generated as a result of BHC involvement would reduce the cost of mortgage funds and increase the availability. Clearly, this reduction in cost would benefit consumers.

The CHAIRMAN. Senator Bond, you're certainly next. Mr. Guthman has arrived and you can now either question the witnesses and then have Mr. Guthman make his 5-minute opening statement or have him make his statement and then ask questions, whichever you prefer.

Senator BOND. Mr. Chairman, I, unfortunately, am on a tight time schedule today and I certainly will take our distinguished colleague from Utah's endorsement of Mr. Geltman's proposals. Like Senator Garn, I sort of feel it's deja vu all over again because Mr. Geltman and I have made the arguments in front of congressional committees for a number of years when he was my right hand man when I served as chairman of the Governors' Committee on Community and Economic Development.

Mr. Geltman, I appreciate very much your discussion of the basis point advantage and safety and soundness. I think those are two points that skeptics might well raise, whether the lower cost or the lower rates for general obligation bonds are the result of the increased competition with bank participation or whether it merely comes from having the full faith and credit behind the bonds.

I do know that in the State of Missouri that we issued in my last term general obligation bonds and revenue bonds almost contemporaneously and the general obligation bond bids were won by a large State Missouri banking organization which offered the best rate. I really can't think of any further questions because Mr. Geltman has covered that area very well.

BANKING SERVICES

I would ask Mr. Fox, have you made a study to determine how much it would cost banks to offer the lifeline banking services you recommend?

Mr. FOX. No, we haven't. I believe that the limited nature of these sorts of services, the limits on transactions, for example, would make it possible for banks to break even or perhaps even make a profit on these accounts. There are a number of banks that are offering accounts of this nature and I don't believe they are offering those accounts at a loss.

Senator BOND. But you would tie any other expanded powers of banks to your proposal for a lifeline banking, despite the fact that one of the public policy concerns that we have about the banking industry is maintaining safety and soundness. You feel that despite our safety and soundness concerns about banks, you would be willing to sacrifice that in favor of the lifeline services that you propose?

Mr. FOX. I don't believe that offering of services to low and moderate income consumers sacrifices safety and soundness. Indeed, I would argue the opposite, that safety and soundness of the system is, to a large extent, dependent on the perception of consumers that the banking system serves all consumers and not merely the afflu-

ent or the well-to-do. At the point where the banking system does not serve all the consumers and is not accessible to all consumers, that's where confidence in the system will erode. That's where it will become difficult politically, if in no other sense, for Congress to ensure that the system remains safe.

I think it's imperative that all consumers have access to a basic level of banking services.

Senator BOND. I can understand the political argument which you are making here today and I'm sure you will continue to make. But if you have any studies which would indicate the impact on safety and soundness, I'm sure we would welcome having them for the record. Mr. Geltman mentioned several studies and, Dick, I would appreciate seeing copies of those. And, Mr. Fox, if you have any, I would welcome those.

[Information not received at time of publication.]

I might ask Mr. Kaufman if you have any comments on the lifeline proposal that Mr. Fox has made.

Mr. KAUFMAN. Well, I believe that with 14,000 banks and 3,000 S&L's—falling every day but still about 3,000—18,000 credit unions, a number of savings banks, I think competition, if there is indeed profitability in those accounts and goodwill that would benefit the bank, then I think competition would encourage this type of service to be offered. And as Mr. Fox said, a number of banks—and I think it is an increasing number of banks—are now offering them. I would leave it up to the marketplace.

Senator BOND. Mr. Kaufman, do you think there are any securities activities that banks should not participate in and do you have any views—I know you focused on mutual funds, do you have any views about the powers as to insurance and real estate?

INSURANCE AND REAL ESTATE

Mr. KAUFMAN. Well, I think insurance and real estate, as opposed to securities, is where bank entry can make the greatest benefit. I believe that the insurance delivery system is probably the most inefficient of any of the financial delivery systems and that bank entry into that area in particular would have major impact on reducing the price of insurance to consumers.

In the real estate area, I've never been quite sure why real estate is a financial good. I sort of view it as solid wood, brick, et cetera. Real estate finance, of course, banks are in. I have no great objections to banks going into real estate because again, as an economist, I believe in competition, and unless there's some evidence that there are some safety and soundness effects, which I don't believe there are, or that the antitrust laws are not sufficient to prevent excessive concentration or conflicts, I wouldn't object to it. But I don't see any great benefit.

I think once we get into the equity area, banks owning them as principal for their own account, I favor it subject again to the appropriate SEC provisions that are applicable to nonbanks as well as banks.

Senator BOND. I might ask Mr. Sabin whether you agree with your colleague from the home builders in the testimony that banks

should not be given real estate investment and development powers. What's your view on that?

Mr. SABIN. I very strongly believe that they should not be given the powers. I could give you a 45-minute oration on it explaining all the reasons, but I think most of them are pretty obvious.

Senator BOND. We'll take your promise that you could give us that and we'll spare you having to give the 45-minute oration.

One of the things that we are considering in the Agriculture Committee is the creation of a secondary market for farm loans and one of the arguments being raised there is that this would result in lower interest rates for farm borrowers.

Do you think the secondary market for home mortgages has helped home buyers with lower interest rates?

Mr. SABIN. Very definitely, yes.

Senator BOND. Mr. Colton?

Mr. COLTON. Just to expand on that, I think that there is some pretty good information, although it's always hard to pin down the number on the activities of the secondary market related to Freddie Mac, Fannie Mae, and Ginnie Mae. They have clearly influenced the price of the mortgage in the range of at least 25 basis points, if not 35 basis points. That kind of activity has certainly provided a real benefit in terms of access to a different kind of investor in those mortgages, as well as to a more liquid market. This is especially true in the volatile marketplace that we've seen over the last few years with rising and falling interest rates.

Senator BOND. Thank you, Mr. Colton.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Mr. Colton, I was struck by your testimony about the substantial degree of market concentration in the mortgage-backed securities business.

Am I correct in noting that according to your statistics at year end 1986, 58 percent of the mortgage-backed securities business was in the hands of only two firms and that 96 percent was in the hands of just ten firms?

Mr. COLTON. That is exactly correct. Those two firms were Salomon Brothers and First Boston as far as the activity in 1986. In 1985, in fact, their concentrated activities were even higher than that. Although it's very difficult to put a price tag on what greater competition will do, I think it's pretty clear that when you have a highly concentrated market, that greater competition will make a difference for the home buyer and the consumer, not just in terms of rates but in terms of access to various areas of the market.

Right now, if somebody wants to have an issue underwritten, they basically have to go to Wall Street on a third party basis. This proposal would obviously allow small towns and people who are involved in more local markets to access this activity as Dr. Kaufman mentioned earlier.

The CHAIRMAN. If banks were permitted to enter the mortgage-backed securities business, competition would clearly improve. Is it your testimony and that of your association that mortgage-backed securities underwriting spreads would decline if banks were to enter the business? If so, could we also expect the cost of mortgage credit for households to decline, other things held equal?

Mr. COLTON. I think the answer to both of those questions, Mr. Chairman, is yes. I would be hard-pressed to give you a number. We could probably have a study done and come up with 5 to 15 basis, but I think nobody really knows what would happen. When you see the kind of concentration that exists, there is no question in my mind that it would help the consumer in terms of rates and access. Let me just mention one other point, too. We talked about the benefit to the home buyer. I think the other benefit that comes from this, quite frankly, is to the small investor. If you have these kinds of mortgage-backed securities underwritten on a local or regional basis, I think investors will have the opportunity to access mortgage-backed securities which now are sort of obscure and hard for them to reach, but have a very positive yield and a very high quality. They will have better access because they will understand through a local or regional institution what those investment opportunities are. So I think it helps the home buyer. I think it also helps the investor to have access to these securities.

The CHAIRMAN. You say 10 basis points——

Mr. COLTON. That's just——

The Chairman. But I think we would like to get as specific as we can get here. Supposing you have a $100,000 mortgage. Over the life of the mortgage, what would that save the home buyer if we had the kind of competition that you're suggesting that we could provide?

Mr. COLTON. Let's see. If you had a $100,000 mortgage, over the life of the mortgage a person would pay something in the range of $250,000 to $300,000, depending on the term of that mortgage. Ten basis points is, very quickly off the top of my head, probably somewhere in the range of $500 to $1,000. We'll be glad to give you some specific numbers on that.

The CHAIRMAN. I think all of us would like to have $500 to $1,000.

Mr. COLTON. I suspect so. Again, I would say that nobody would know or give you an accurate number but that it's very clear that you certainly could get into a real investment to the home buyer or the saver.

The CHAIRMAN. Mr. Guthman, I apologize. You were scheduled to be on later and you were here promptly as far as the usual situation would be, but we decided to put all six on together. You go right ahead with your 5 minute statement, sir.

STATEMENT OF RICHARD GUTHMAN, ON BEHALF OF THE NATIONAL LEAGUE OF CITIES

Mr. GUTHMAN. Well, thank you, Mr. Chairman. I appreciate your courtesies.

It is a little bit I guess deja vu. It seems that in 1979 I was probably sitting in this same chair discussing the same subject. I must also say that generally those of us in local elected offices who represent the public erroneously are accused of always coming to Washington with our hat in hand seeking money. It's a pleasure to be here not seeking money but the opportunity to have another tool at our disposal to do what the apparent will of the public in

general is, that the State and local governments to operate more on their own and be more resourceful.

I think most of us welcome that opportunity, but at the same time we would like to have those tools at our disposal with which to be more resourceful and more innovative and certainly the idea of having commercial banks underwrite revenue bonds is another one of those tools.

Two things I think basically have changed since my last opportunity to appear before you on this same subject. One is, more and more financing is being done through the revenue bond issue as the voters tend to be less and less interested or of the nature to tax themselves for general obligation purposes but rather like the idea of using user fees, which means more and more of our activities are being financed in the revenue user fee vein.

The other thing that's changed considerably is my hair has gotten much grayer than it was in 1979 and perhaps brought about by the continuing—for what I think are the wrong reasons—taking away from local governments the ability to do things, taking away funds, which is certainly whatever the public desires in that, but not giving us the kinds of new things that we need. And our ability to issue bonds to finance our most needed capital needs, our infrastructure—which is that great wonderful word—I used to think the infrastructure was the organization of the Viet Cong. I didn't know what it meant until some 14 or 15 years ago when I got involved in this advocation of being a local elected official.

The point is that in this last tax reform act, our ability to issue tax-exempt bonds has been severely limited and hurt by the various regulations and parts of the law, the alternative minimum income tax, et cetera.

One thing, though, that has just occurred, in the passage of the bill and the compromise worked out between the Senate and the House on the FSLIC bill, it was our understanding—NLC's understanding prior to going in that the bonds that were to be authorized were not going to be exempt from State and local taxes. And we had a number of assurances, in fact even from your staff and others, that what would come out with these bonds would be taxable by State and local governments, the interest on them.

Now we find, however, in the compromise agreed upon that they will be exempt from State and local taxes. Very frankly, we are somewhat shocked at that. We are in a quandary. We don't know what to do. We sort of seek your help. The State and local governments, because of not being able to tax the interest on these Federal lookalike bonds, are going to be, in essence, subsidizing the bailout of the savings and loan industry. We don't think that we should be part of that and we would seek your advice and your suggestions on that.

As far as our ability to go to the commercial banks, my testimony—I understand Senator Garn said earlier—is essentially what I said in 1979. It's probably three or four pages shorter. The need is even greater today than it was then, and I would certainly hope that in the next year when you have the opportunity to review this, the legislation will change and we will be able to come back and we will be able to get into a broader market.

Thank you, Mr. Chairman.

[The complete prepared statement of Richard Guthman follows:]

The CHAIRMAN. Thank you, Mr. Guthman.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman. As I understand it, Mr. Fox, you dissent generally from the views of those at the table who feel that there ought to be an expansion of product offerings by banks. You have reservations about that, is that right?

Mr. FOX. I wouldn't say that we dissent from the proposition that that ought to be something that's done. I tried to make it clear that that's something that we recognize some benefits, we recognize some costs and some considerations that need to be taken into account, if that sort of policy is to be pursued.

My specific concern with bank underwriting mutual funds is not that there are great unmanageable dangers or great problems that are caused by that, but simply that the benefits of such a policy do not accrue to the vast majority of American consumers and I'm seeking here today to urge Congress to take those consumers into account and to recognize that financial restructuring needs to have some components that benefit the average consumer and not merely those consumers who have a wide variety of choices and have a lot of places to put their savings today, and wanted to use this opportunity to suggest one way in which banks could be called upon to recognize that their obligations are to the entire community they operate in and not merely to the consumers who are the most affluent.

Senator RIEGLE. Let me ask the rest of you, in addition to these expanded activities—many people raise the point that additional products are a continuum of which these are a part. Maybe these are the part that is most closely related to what banks now do. If you start down this continuum you move on into related activities, into direct security underwriting, security offerings, insurance, real estate, a whole host of other related financial service type activities that banks presently are not for the most part doing.

If you have thought about that, I would say to the other five at the table, are there any of you that have concerns that while you see benefits generally in taking steps in these areas you would see further steps along that continuum as posing problems, or have you thought about that? Does anybody have a view on that that they would like to share?

Mr. GELTMAN. I think from our viewpoint that no one knows the answer. One of the benefits of the dual banking system is that we have nationally chartered banks and we have State chartered banks, for State chartered banks each State can make its own rules. Therefore, there can be some experimentation, and we can learn from the experiments that occur.

One of the concerns that we had with the moratorium incorporated in the recently passed banking legislation is that it prevents States from permitting State chartered institutions to do some of that experimention from which we can gain experience. Some experiments may work out very well. There may very well be some powers that are inappropriate, but it's better to find those out in the real world than merely to speculate on what they are. And with 50 State laboratories out there, we will have the opportunity to find out where there may be some problem areas. At that point

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STATEMENT OF

MR. RICHARD GUTHMAN

COUNCILMEMBER, ATLANTA, GEORGIA

on behalf of

THE NATIONAL LEAGUE OF CITIES

on

BANK UNDERWRITING OF REVENUE BONDS

before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

August 6, 1987

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Statement
of
Richard Guthman
Councilmember, Atlanta, Georgia

Good morning/afternoon, Mr. Chairman and members of the Subcommittee. My name is Richard Guthman. I am a Councilmember in Atlanta, Georgia, and I am here this morning/afternoon representing the National League of Cities--the largest and oldest organization in the country of publicly elected officials of the nation's cities and towns.

For several years, I have served as a member of NLC's Finance, Administration, and Intergovernmental Relations Policy Committee. We appreciate this opportunity to appear here today to clarify our reasons for supporting legislation that would permit commercial banks to underwrite and trade in investment quality municipal revenue bonds. NLC has supported such legislation for more than 15 years, and has included a formal policy to that effect in our National Municipal Policy adopted annually by our membership.

I do not wish to reiterate the entire history of the Glass-Steagall Act since its enactment in 1933. But there are important changes that have occurred over the past 50 years deserving of the committee's focus.

In 1933, General Obligation (GO) bonds financed virtually all local government construction projects while revenue bonds were rarely used as a municipal finance instrument. However, the number of revenue bonds issued in 1970 constituted approximately 34 percent of all new long-term municipal financing. That percentage rose to approximately 63 percent in 1978 and furthermore to about 70 percent in 1984. This is a marked turnaround from the long past days of the enactment of Glass-Steagall, when commercial banks could still underwrite GO bonds under that Act.

This steady trend away from GO bonds toward revenue bonds backed by user fees is likely to continue. Simultaneously, the federal government has eliminated general revenue sharing, and state and local governments must meet stricter limitations resulting from "Proposition 13" - type initiatives and balanced budget laws. All the while, the changes occurring in the face of Glass-Steagall have created an economic regulation nest for non-bank securities underwriters, preventing a conservatively estimated interest savings to municipalities of approximately $125 to $250 million.

State and local governments use revenue bond issues for providing the financing for such essential public projects as roads, bridges, public transit, airports, water and sewer projects, power systems, and all types of public buildings. The need for

these projects is not going to abate. I can tell you first-hand as a local elected official that voters, in general, are more and more reluctant to approve general obligation bonds for any purpose primarily because of the resulting add-on to their tax rates. On the other hand, the general public and elected officials are increasingly attracted to the "user-pays" concept for public services offered by revenue bonds. Revenue bonds are equitable because the revenues from the project financed are used to meet annual debt retirement costs.

We can no longer afford, now more than ever, to reserve the underwriting and reoffering business from these issues to a small number of firms. Commercial banks should be allowed to participate in this market place in order to assure greater competition so as to keep costs to the issuers as low as possible and to assure that enough capital is available to handle the market.

I am quite sure that this Subcommittee has heard conflict testimony as to the amount of nationwide savings to state and local governments if commercial banks were allowed to underwrite bonds. More than a dozen research reports on this issue have now been completed. As one might expect, those supported by the investment banking community tend to show negligible cost savings. Those cited by the commercial banks show marked savings. Projections have ranged from $80 to $380 million. William Silber, who has analyzed the studies in depth, projects a more likely cost savings of $125 to $300 million for municipalities. Robert Lamb, publishing in the Municipal Finance Journal in the summer of 1984, similarly estimates $125 to $250 million. Lamb emphasizes "the crucial fact is that, regardless of the range chosen, there is a marginally significant savings amounting to between $1.50 and $4.00 per bond, a by no means inconsiderable amount."

We believe that the entry of commercial banks into this business would increase competitiveness in two ways. First, the banks would provide more competition on many new underwritings upon which they forwarded bids. Secondly, the presence of this second industry in the bond market would increase the potential pool of ultimate buyers via their additional lists of clients and contracts.

Yet these are unrealized savings. Under the situation as it now stands, we still have a "closed shop" despite a rapidly changing environment in municipal bonding. In recent years, more than two thirds of the revenue bonds issued nationwide have been sold on a negotiated, one-bid basis to an investment banking syndicate. State and local officials have been faced with a take-it-or-leave-it proposition, no matter what the interest costs are. The general obligation bond market has in recent years produced approximately 90 percent sold on a competitive basis. We believe the result has been generally lower interest costs producing substantial savings to the taxpayer.

I cannot emphasize enough the cost saving aspect of this issue. Just as you feel pressure in the Congress to cut costs and reduce the deficit so, too have local officials felt greater pressure than ever before to economize. As we continue to search for more creative and innovative ways of financing, we hope that the elected officials at the federal level will concur with the nation's local elected officials. Removing the barriers to a competitive market in the revenue bond industry will help assure that revenue bonds continue as a positive alternative and that their costs will be kept to a minimum.

Congress and the States can step in and prohibit them from occurring.

It seems to me that we are a long way from where we were in the unregulated depression years of the 1930's, that we're in a new world, and that we ought to have the opportunity to try some things out. Recognizing that you're not going to have a uniform rule if you permit State chartered institutions to do the experimenting, you will be able to have the benefit of some real experience.

POTENTIAL PROBLEM AREAS

Senator RIEGLE. Well, I hear that but that really wasn't what I was asking. What I was asking was, do you see any potential problems in coming down the continuum of additional kinds of products, different kinds of products, being offered by commercial bankers? Would you, as a group—I mean as individuals at the table here, but would you be concerned or would you favor the notion of going beyond these areas—municipal bonds and mortgage-backed securities and mutual funds? How about the underwriting of corporate securities directly? Many banks want to do that and they are asking to do that, hoping to do that. The administration has the view that they ought to be able to do that, that they are moving in the direction of sort of one-stop shopping or other kinds of financial services insurance, real estate. Do any of you have a strong feeling, pro or con, that commercial banks should or shouldn't get into those other activities?

Mr. COLTON. Senator, as I mentioned in my oral statement before you came in, the National Association of Home Builders has often expressed concern about direct investment in real estate by banking institutions, both because of safety and soundness reasons and because of our concern in terms of a lot of competitive questions and the issues that arise in the marketplace.

In looking at this issue, we obviously recognize that if you begin to expand the powers, there will certainly be a dialog that will take place about what those powers ought to be. I think our feeling, particularly as it relates to mortgage-backed securities and the ability of banks and thrifts to underwrite them, and as it relates to some of these other securities powers, that the benefits do outweigh the risk, and we think that there should be legislation that would allow this kind of activity for the banks.

We think you have to look at each item separately and look at the merits and the benefits and costs. We obviously recognize that the world is evolving, but we need to be sophisticated to make those kinds of choices and decisions.

So, yes, we have some concern along those lines. We do oppose certain of these bank activities rather vehemently. But we think that that should not prevent us from approving those that are appropriate.

Mr. GELTMAN. Senator, if I may, States have permitted a number of State chartered institutions to engage in related banking activities, whether they are travel, real estate, or insurance powers. So far there does not seem to be any indication that that has created a problem of safety and soundness. To the extent that we have had

major problems with institutions, they seem to revolve around bad management, and bad decisionmaking, but they do not seem to have occurred as a result of the particular powers that have been exercised.

Mr. COLTON. Just one last quick comment. I think where we came out on this issue is that Congress ought to make those decisions and that's why we supported the notion of the moratorium. And I think our sense is that if public policy is made where public policy is supposed to be made, we can make those good judgments.

What we were concerned about is having new activities move out of hand and we supported the moratorium along so you could make those tough choices.

Mr. KAUFMAN. I have one comment, if I may, on this. I believe that the banks should be permitted to engage in almost any financial service unless we have evidence that it increases risks or that it is detrimental in terms of concentration or conflict of interest.

I think the most important thing, though, is competition. I changed my own mind on this just in the last 10 years, primarily because 10 years ago it was very difficult to get a bank chartered and competition was rather limited. Now it's easier to get a bank chartered even with the closing of the nonbank bank loophole, which I think I disagree with. I think the most important protection to the consumer is competition and the only way we can guarantee competition is by having ease of entry. And if we have that, then dissatisfaction with individual banks will permit people to move to other banks and other institutions.

Ten years ago, when we limited bank charters, that was not true.

Mr. SABIN. Senator, may I respond also?

The CHAIRMAN. OK. That was quite a question you asked.

Mr. SABIN. Well, you discussed the continuum and that, if we support these, do we therefore support the continuum.

I would have to say, yes, we support this part, but we do not support the continuum. You can take the continuum to the part where because they finance cars should they sell cars in their lobby?

There's an extreme to this wherever you go and, as has been discussed before, there's the safety and soundness which is very important. The competition is right if competition is fair. Those are things to be concerned about.

Senator RIEGLE. And I take it, representing the real estate folks, you might be a little concerned about tie-ins as it relates to real estate activities on the one hand and mortgage lending on the other?

Mr. SABIN. Thank you for saying what I would have said. Thank you.

The CHAIRMAN. Mr. Geltman, in your statement you cite a variety of studies that indicate that bank authority to underwrite municipal revenue bonds would reduce underwriting expenses by increasing competition in that business.

Could we expect that State and local tax costs would be moderated by the lower underwriting expenses?

Mr. GELTMAN. I think what we anticipate is that the financing of the structures that had to be built would be reduced and that the costs that had to be picked up would be reduced. Therefore, whatever the financing mechanism for those bonds was would I assume

reflect the saving and reduced to be the same level that was necessary to pay off those bonds. So assuming that you're using a user charge to pay off the bonds financing the facility, I believe that the user fee, whatever might be, would be less if the financing charge is less.

The CHAIRMAN. Mr. Guthman, you say that 90 percent of the general obligation bonds issued nationwide are underwritten competitively, whereas more than two-thirds of revenue bonds are sold to an investment banking syndicate that is the sole bidder.

Do you attribute that difference to the fact that banks can underwrite general obligation bonds but not revenue bonds?

Mr. GUTHMAN. Do I attribute the fact that they can only underwrite general obligation bonds?

The CHAIRMAN. They can only underwrite general obligation bonds and not revenue bonds, that's right.

Mr. GUTHMAN. No. I would say that my experience showed that when there's an issue to be brought to market that the political pressures brought on the finance officials of local governments to negotiate with one or a few investment houses is very strong. All kind of arguments which I think are not necessarily correct say you should not competitively bid. I think that experience in Atlanta on some rather large issues in the past, revenue issues, that were competively bid—it's easy to negotiate with one or two people and it's certainly easier on the house that has the inside track, but I think that those who want to continue to negotiate would still negotiate whether it would be banks as the underwriters or whether it be investment bankers. I think the banks have the same degree of capability as anybody else as to whether or not it's going to be a competitive bid or negotiated.

The CHAIRMAN. So you feel that if banks could underwrite revenue bonds that you would have more competition and lower cost to the city that you represent?

Mr. GUTHMAN. I think that if the greater entry should result in lower costs, then whether or not it's on a negotiated basis or whether it's on a competitively bid basis, the more people you have to deal with, the more likely the cost is going to be less.

The CHAIRMAN. Mr. Kaufman, the Washington Post reports today that a study by the Federal Reserve Bank of Atlanta indicates that banks with assets below $50 million have become far less profitable over the last 5 years. In addition, the study found that all banks have become less profitable in 1986, partly because of reserves but that will be shown up in 1987 when the money center banks made the colossal shift into reserves.

In light of these trends, shouldn't we be looking to expand bank entry into the mutual fund area in order to permit diversification? Wouldn't that provide a much needed additional source of revenue for the banks, especially the small banks?

Mr. KAUFMAN. Yes. It would produce additional revenue. The mutual fund business, by the way, is almost very riskless. It's tied to the volume of mutual funds sold. So when we talk about risks, there's a different kind of risk in mutual funds.

The CHAIRMAN. As a matter of fact, I've always maintained that revenue bonds may be less risky than general obligation bonds. You can figure mathematically with the revenue the number of

times it covers your interest costs. For the life of me, I can't understand why revenue bonds are excluded except that they weren't really significant at the time when Glass-Steagall was passed. So they were omitted because they didn't amount to anything.

Mr. KAUFMAN. I would think so. Going back and reading Glass-Steagall and the intent is very, very difficult, but as I remember reading it, there was some attempt to also prohibit the banks from underwriting general obligation bonds. But it was noted that the investment banking industry, which had gone through very hard times in those years, was not able to finance all the general obligation bonds so they put general obligation bonds back in. Revenue bonds were not very important.

Certainly since the New York City affair, general obligation bonds have not been viewed in the same way.

But mutual fund activity certainly is just tied to the volume of mutual funds that you sell and would not increase the bank risk factor considerably, if at all.

The CHAIRMAN. Mr. Geltman, what is the default rate on revenue bonds? Let me ask three questions together and you can hopefully put the answers together.

Are the bonds guaranteed or collateralized by anything besides the projected revenue to be derived from the project; and should a bank be allowed to hold the bonds in their investment portfolio or should this practice be strictly prohibited? Start with the first one. What's the default rate on municipal revenue bonds?

DEFAULT RATE ON MUNICIPAL REVENUE BONDS

Mr. GELTMAN. Determining the default rate is one of the areas in which we have some real problems, I think we know what the default rate is for all municipals; it's been recently calculated by someone in Chapman and Cutler in Chicago. For the default rate of all bonds, and I think it goes back to about 1940 right up to about 1983 or 1984, is 0.2 of 1 percent. But it's very difficult to factor out municipal revenue bonds. There are three different kinds of bonds and as far as I know the default rate has not been allocated yet between general obligation bonds, municipal revenue bonds of the traditional variety, and private purpose industrial development bonds. I can try and get through to some of the people I've been working with to come up with some figures on that. In preparation for this hearing I was not able to get those figures.

The CHAIRMAN. Now the second part of my question was, are they collateralized by anything except for the revenue?

Mr. GELTMAN. I think general municipal revenue bonds of the traditional variety are only collateralized by the stream of revenue itself.

There exists right now municipal bond insurance. As you get further into private activity bonds, many of them—I'm not sure what the figures are—I think it's somewhere between 30 and 50 percent, are in fact collateralized. I'm not sure of the exact figure for traditional municipal revenue bonds of the kind that are done for public purposes. Once again I can work to give you an answer on that question.

The CHAIRMAN. And the final question was, should a bank be allowed to hold the bonds in their investment portfolios or should that practice be strictly prohibited?

Mr. GELTMAN. I think that there's no reason why they should not. They should be treated in the same way that general obligation bonds are. As indicated earlier by Mr. Kaufman and I think by your own discussion, it's hard to determine if there's any difference in risk between many of the revenue bonds and general obligation bonds.

The CHAIRMAN. Mr. Fox, there was a statement in your prepared remarks which concerned me and perhaps you could help me with it.

Many groups advocate the financial supermarket approach to the delivery of financial services. If banks were given the power to underwrite mutual funds, they would want to sell the mutual funds through their existing branches.

On page 1 of your statement you say, "It may be necessary to prohibit or severely restrict cost marketing of operations by a bank and affiliated mutual fund at the same location."

Why do you say that? What's your reason?

RISKS OF CONFUSION

Mr. Fox. I think there's a very serious risk of potential investors in mutual funds encountering these funds at a bank location will be led to believe or will draw the inference that the mutual funds are federally insured. I think that's one of the most serious problems that needs to be dealt with in defining the terms and conditions under which mutual funds are marketed by banks or by bank holding companies.

There's already a great deal of confusion among consumers about what financial products are federally insured and which aren't. Offering a mutual fund inside the bank with the FDIC emblem on the door of the bank by a sales person who has other literature with the FDIC emblem, I think may unduly increase the possibility of confusion.

The CHAIRMAN. Why not just require conspicuous and full disclosure? In other words, to anybody investing in mutual funds you say, "Our deposits are insured by the FDIC but our mutual funds and other services are not."

Mr. Fox. As I suggested, I think that's the minimum step that should be taken.

The CHAIRMAN. Why wouldn't it be enough?

Mr. Fox. What I suggested is that that should be looked at by Congress to determine whether that is sufficient or not. I think it may well be enough to ensure that any written or promotional material very clearly, very explicitly states that the mutual fund is not insured by the FDIC or any other arm of the Federal Government. But I think that's a legitimate question for Congress to look at in developing this policy as to whether that's going to be sufficient. If it's not sufficient——

The CHAIRMAN. If you apply that standard, it seems to me it really would inhibit expanding bank services, if you make the im-

plication that you're going to deceive people by giving them the impression that whatever they get at the bank has Federal insurance.

Mr. Fox. Well, I think there's a unique problem here because the service that's being dealt with is a deposit service that looks and feels to consumers like other services offered by the bank in the traditional setting, like other deposit services. I don't think there's the same risk of that confusion if a bank is brokering real estate, that somehow people will believe that there's Federal insurance there. Now there are other problems with real estate. There are other problems with insurance sales. But confusion as to whether there's a FDIC guarantee of a deposit account is something that seems to me to be unique to the mutual funds, Senator.

The CHAIRMAN. Professor Kaufman, this is the first time I've heard this point raised that Mr. Fox raises here. It's somewhat troublesome. What's your view?

Mr. KAUFMAN. Well, I agree with you that we need to have full disclosure that these are not insured by the FDIC. I wish we also had that on accounts over $100,000. A lot of people think that the FDIC does insure those.

I think Mr. Fox may be confusing the money market mutual funds and the stock mutual funds. Money market mutual funds in many ways act like deposits and look like deposits to consumers. They have a par value, even though it's not guaranteed. Once you get into the stock and longer-term bond mutual funds, they fluctuate in value and I don't think that the consumers are confused there.

On the money market funds we do have a par value. I think it is important to specify these are not insured. Also, these funds are reasonably safe because without insurance the mutual funds know that they have to invest in very short-term, very high-quality assets and that's the only way that they are able to maintain the value on the fund side on the share fund at par value. The SEC permits mutual funds to quote their shares at par value if the average maturity of the investments is less than 120 days.

The CHAIRMAN. My time is up. I'll yield to Senator Chafee in just a minute, but if he will permit, let me follow up on this question a little by asking if you or anybody else at the table has any notion of the record of mutual funds in terms of safety and soundness?

SAFETY OF MUTUAL FUNDS

I've always had the impression, because they are diversified, because they represent a large number of investments, that by and large they are safe and sound, about as safe and sound as you can get. Perhaps I've misunderstood.

Mr. KAUFMAN. It depends on what you mean by safe and sound.

The CHAIRMAN. Safe and sound in the sense that your investment isn't going to disappear the way it would if you made one loan that went bad or if you invested in a single company that went belly up.

Mr. KAUFMAN. Well, you are a shareholder in a mutual fund. It cannot go bankrupt by definition because your ownership in the mutual fund is exactly equal to the pro rata share of the portfolio of the mutual fund.

The CHAIRMAN. That's what I mean.

Mr. KAUFMAN. Now there have certainly been some mutual funds in recent years that have done very poorly. I know. I invested in a couple of them.

The CHAIRMAN. I don't mean that your investment won't diminish. I mean it's not going to disappear.

Mr. KAUFMAN. No, it can't, because you own a share of the investments on the portfolio side, on the asset side.

The CHAIRMAN. Thank you.

Senator Chafee.

Senator CHAFEE. Mr. Chairman, I regret I've been in the middle of and still am in the hearing in the Environment Committee where we are dealing with a major matter down there, so I regrettably haven't been able to be here.

I have a statement I would like to put in the record.

The CHAIRMAN. Without objection, it will be printed in full in the record of the hearing.

Senator CHAFEE. I will read over the testimony that's given here because we're getting right to the subject of which has been a major concern to this committee and this panel is dealing with it. So I'm sorry there are not more here. Where is everybody?

The CHAIRMAN. Well, about six or seven others have been here, although they're gone now.

Senator CHAFEE. Thank you.

The CHAIRMAN. Mr. Sabin, on page 2 of your testimony, you refer to the second and third generation mortgage securities that have been created in the 1980's, CMO's, REMIC's, MBS's and so forth. These securities are apparently quite volatile. As an example, Merrill Lynch recently lost over $275 million from stripped mortgage-backed securities transactions. We had a witness just last week, Mr. Martin Mayer, who advocates bank underwriting of commercial paper, mutual funds, municipal revenue bonds, but not mortgage-backed securities because they are much riskier than the underlying mortgages.

Are mortgage-backed securities and their derivatives riskier than the other securities powers I mentioned earlier? Why or why not?

Mr. SABIN. I'm sorry, Mr. Chairman Your question was so long that by the time I got to the end of it I had forgotten what the first part was.

The CHAIRMAN. You just answer the last part of the question. Are mortgage-backed securities riskier than the mutual funds and commercial paper and so forth?

Mr. SABIN. Under the proper safeguards, no.

The CHAIRMAN. Well, what are the proper safeguards? Tell me that.

Mr. SABIN. Well, as an example, if there's concern for the institution that's doing this, if you have concern for asset size, for capital ratio, for loan loss reserves, all these things are factors to be concerned about.

The CHAIRMAN. Again, this notion that mortgage-backed securities would be particularly risky puzzles me. You pool a number of mortgages and, of course, bankers are experts in mortgages. That's what most bankers deal with, though perhaps money center banks less so than the smaller banks. But by and large, bankers know

what they are doing when they deal with mortgages. If you're in the mortgage-backed securities, you have a series of mortgages and presumably just the fact that you have a number of them—differentiated mortgages in different areas and perhaps different geographic regions—would make mortgage-backed securities generally quite safe. Isn't that right?

Mr. COLTON. Just adding to that, I think it's important because I agree with you, Mr. Chairman. There's really a difference between the risk involved in underwriting these securities and the risk involved in taking a trading position.

The loss that Merrill Lynch took related to a trading position that they had in stripped securities and the market moved on them in the volatile period when a lot of people got caught in market movements, and that's why they lost a lot of money. It was not a loss from underwriting.

So I think if you realize that distinction, it is not a serious problem to talk about giving them the power to underwrite those securities. There will always be risks involved in taking a trading position, and that's a very different matter. That's why I think there's a lot of misperception about the risks involved in mortgage-backed securities which does not apply to the underwriting of those securities.

The CHAIRMAN. Professor Kaufman, we've been talking safety and soundness. Let's take a look at conflicts of interest for a minute. Those who oppose granting banks new mutual fund powers argue that serious conflicts of interest would arise between sponsoring mutual funds and making commercial loans. Yet quite a few securities firms that sponsor mutual funds have affiliates that are in the commercial lending businesses. For example, Kidder-Peabody is affiliated with General Electric Credit Corp.

Do you believe that a bank holding company is more likely than a securities firm to succumb to conflicts of interest?

Mr. KAUFMAN. No, it's not any more likely. But, on the other hand, it's not any less likely either. The problems are going to be the same in banking as they are in insurance, investment banking, et cetera. But certainly banks are no more likely to engage in conflicts than their competitors.

The CHAIRMAN. Mr. Colton, I want to go back to that mortgage-backed securities issue in a slightly different way.

You point out that banks have been active in the private placement of mortgage-backed securities and that private placement is declining in relation to public offerings of such securities. You suggest that the dominance of the mortgage-backed securities market by a few investment banking firms might even increase.

Can you elaborate on that point?

Mr. COLTON. Yes, I would be delighted to. Obviously, over the last few years the mortgage-backed securities market has become fairly complex and you have what is referred to as the conforming market that relates to mortgages which are placed within Freddie Mac and Fannie Mae, and then you have the nonconforming market. Also you have the ARM's market that has developed over time and the market which has developed related to mortgage-backed securities in ARM's.

What's happened with private placement is jumbo loans which are nonconforming, as well as ARM's loans, have over time been placed as securities on a private basis, i.e., a bank or an S&L will take those securities and sell them to a single investor. That practice actually has been declining over time with the growth of other activities, and with the growth of REMIC's and CMO's, et cetera. So those institutions are losing access to that marketplace and authority to underwrite will allow them to be more competitive in terms of the large majority of mortgages that are being issued in that marketplace.

The CHAIRMAN. Professor Kaufman, you pointed out in your written statement that banks and bank holding companies already exercise a variety of powers related to mutual funds. They act as investment advisers to mutual funds. They sponsor, organize and manage closed-end investment companies. They operate common investment funds for their trust customers. They also buy and sell mutual fund shares on behalf of their customers. Some banks have even started private label mutual funds for which they do almost everything except act as principal underwriter. That adds up to a lot of bank activities involving mutual funds.

The interest groups that oppose making an exception to the Glass-Steagall Act for mutual fund activities say that such activities by banks will lead to all sorts of dire abuses.

To your knowledge, have such abuses been a problem in recent years?

Mr. KAUFMAN. I have not heard of any, no.

The CHAIRMAN. Anybody else at the table have any other views on that?

[No response.]

Mr. KAUFMAN. Well, I don't think the profits from mutual funds are that great. I don't think the banks are going to die if they can't offer them, but as you just pointed out, they are effectively doing it now anyway. And if you take a look at this new Chase account, it is in all practical ways sponsoring, as well as managing, a mutual fund.

But is it a question of life and death for the banking system? No.

The CHAIRMAN. Gentlemen, I want to thank you very, very much. You have been an excellent panel. I'm tempted to go on because this is such a critical area and it's going to play a big part in the legislation we are very anxious to write.

Thank you and the committee stands recessed.

[Whereupon, at 11:35 a.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

1125 Fifteenth Street, N.W.
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Mortgage Bankers Association of America

Burton C. Wood
Senior Staff Vice President and Legislative Counsel
202 861 6507

August 31, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing, and Urban Affairs
United State Senate
Washington, DC 20510

Dear Mr. Chairman:

This letter is submitted with respect to hearings the Senate Banking Committee has been conducting throughout the 1st Session of the 100th Congress (most recently on August 6) pertaining to expanded powers for depository institution holding companies. The Mortgage Bankers Association of America respectfully requests that this letter be included in the official Committee hearing record.

MBA supports those provisions in S. 60, the "Financial Services Competitive Enhancement Act of 1987," introduced by Senator Jake Garn (R-UT), Ranking Minority Member of the Senate Banking Committee, that would grant bank and thrift holding company affiliates expanded securities powers. In particular, MBA strongly supports the authorization of these financial institutions to underwrite and deal in privately issued mortgage-backed securities (MBSs).

The growth of the private secondary mortgage market is particularly important in light of ongoing initiatives of the Administration that focus on reducing the role of the federally sponsored mortgage credit entities, such as the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC), in the capital markets. Fortunately, the importance of improving the flow of funds to the housing sector has been recognized by Congress, which has encouraged the growth of the secondary mortgage market. While the programs offered by these federally sponsored entities are an important element in enhancing affordability, there remains a vital need for more and stronger entrants into the private MBS marketplace.

Bank and thrift institutions are currently able to underwrite and deal in MBSs guaranteed by the federally sponsored entities. U.S. banks may also underwrite privately issued securities abroad and are leaders in the Eurobond markets. Ironically, what they can do under current law is somewhat inconsistent with what they cannot do. For example, a bank may purchase whole loans from an originator, then issue and underwrite its own MBS collateralized by those mortgages, but if the originator itself issued the identical MBS collateralized by those same mortgage loans, then the bank would be prohibited from underwriting the offering.

Another troublesome aspect of today's secondary mortgage market is that the underwriting of privately issued MBSs is exceptionally concentrated in the hands of

relatively few investment banking firms. Because of this high level of concentration, these firms are able to set underwriting fees unilaterally with little, if any, price competition. Permitting bank and thrift holding company affiliates to underwrite privately issued MBSs would significantly increase the number of competitors in the marketplace, thereby leading to lower underwriting costs and more investors at the local or regional level. This would create greater liquidity for the secondary mortgage market and lower interest rates for homebuyers. The increased number of participants underwriting MBSs, both on local and national levels, would help ensure that mortgage credit is available in all parts of the country, thus increasing the availability as well as the affordability of mortgage credit.

While MBA believes the expansion of the type and number of institutions participating in the secondary mortgage market will benefit the housing and financial markets in general, we urge the Committee to ensure that there will be appropriate safeguards to protect federally insured depository institutions against certain risks associated with underwriting activities. One possible safeguard could be to require that underwriting activities be conducted by a holding company subsidiary separate and apart from the depository institution to ensure that any underwriting losses would not affect federally insured deposits. MBA believes the strength and integrity of financial markets and institutions are of paramount importance to the housing industry and to the economy.

In discussing risks associated with underwriting MBSs, a great deal of recent publicity has surrounded large losses suffered in MBS transactions. These losses, however, resulted not so much from underwriting as from poorly controlled positions in the market. Also in the past, large losses were reported by Bank of America in 1984 and by a number of investors in 1985 as a result of the collapse of Equity Programs Investment Corp. (EPIC). These were isolated incidents where fraud and misrepresentation, particularly in the appraisals of the underlying properties, played a leading role. The Committee should not view these losses as indicative of normal risks associated with underwriting MBSs.

While the dollar volume of private issues is small compared to that of issues backed by GNMA, FNMA, and FHLMC, the private market has significant growth potential. Market expansion is being stimulated by innovations in market instruments, private sector conduit issuers, and the globalization of the capital markets as evidenced by the attraction of European and Asian investors to MBSs. Congress has contributed to this growth potential with the enactment of the Secondary Mortgage Market Enhancement Act of 1984 (P.L. 98-440), and, more recently, with the inclusion of the Real Estate Mortgage Investment Conduit (REMIC) provisions in the recently adopted Tax Reform Act of 1986 (P.L. 99-514). Legislative initiatives such as these will broaden the secondary mortgage market and increase the liquidity of MBSs, while lowering mortgage interest rates for homebuyers. In light of recent Congressional activity in this area, MBA respectfully urges Congress to continue its support for housing and the secondary mortgage marketplace by enacting legislation that would allow bank and thrift holding company affiliates to underwrite and deal in MBSs.

We would be pleased to furnish any additional needed information to you and Members of the Committee. Thank you for your courtesy in this matter.

Sincerely,

Burton C. Wood

Burton C. Wood

The Coca-Cola Company
ATLANTA, GEORGIA

July 31, 1987

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
SD-534, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing in regard to the hearings on financial restructuring that are being conducted by the Senate Committee on Banking, Housing, and Urban Affairs on August 6, 1987. One of the topics scheduled to be discussed at the hearing is bank participation in underwriting and distributing commercial paper. I strongly urge you to give your full consideration and support to permitting banks to be active participants in the commercial paper market.

In the past, The Coca-Cola Company has placed commercial paper through the services provided by a bank and its affiliate. We were pleased with the services we received and found them beneficial to us and our business.

In order for any business to expand and maximize its profits, there must be a source of funding that is efficient and inexpensive. Traditionally, this funding need was met by commercial banks which acted as intermediaries between the sources and users of funds. Recently, as the result of deregulation of interest rates, increased competition, and economic conditions, banks can no longer provide funds for corporate America at competitive rates. Corporations have turned to the commercial paper market which is extremely efficient and cost-effective. Some have estimated that the difference in cost to a corporation that borrows funds from a commercial bank rather than finance its needs through the issuance of commercial paper may be as high as 250 basis points or 2½ percent of the amount financed. For example, if a corporation had $200 million outstanding in debt and financed it through a bank, it would have an additional cost of $5 million.

It is clear that the commercial paper market has achieved a major position in short-term business finance. As the commercial paper market matures and becomes accessible to more borrowers, banks will face continued erosion of one of their most important loan markets. The impact of a weakened banking industry that is experiencing the loss of a major component of its business is something that should concern all of us. Banks should have the opportunities to develop new avenues of business in financial services in order to maintain the health of the industry. The decline of an industry as significant to our economy as the banking industry does not serve anyone's purpose.

Commercial paper is a natural extension of the business banks have always provided. Commercial paper is essentially a substitute for commercial loans. Our experience has shown us that banks have the expertise and the ability to participate in the commercial paper market.

Bank participation in the commercial paper market will also enhance competition among underwriters in that market. At the present time, the market is dominated by a small number of large investment banking firms. Increased competition will help reduce costs and also improve the opportunities for all businesses to participate in the market.

I appreciate your consideration and hope you will support legislation providing banks with the opportunity to actively participate in the commercial paper market.

Sincerely,

M Douglas Ivester

MDI/ll

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